

# **The Energy Supply Market of the Baltic States: Russia's Role and Prospects for Integration.**

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The most efficient way to enforce energy security is by market regulation of investment in energy and by trading energy supplies as a market guarantee for optimal cash flow. Free energy market development is a main priority of Russian energy policy concerning the Baltic States.

International transit problems regarding energy supply are of special concern to Russia. Russia has diversified its hydrocarbon export route to minimize commercial and transit risks. Recently, Russia has empathized ecological issues when cooperating with the Baltic States. Russia and the Baltic states are both interested preserving the vulnerable ecosystem of the Baltic Sea. Therefore, the main criteria for choosing a transit route are ecological safety, economic effectiveness, reliability and the interests of the transit countries.

The purposes of this study are a detailed analysis and a description of the energy security conditions in Russia; an analysis of the external economic aspects of cooperation between Russia and the Baltic States; a study of the aspects of international energy transit, and; research regarding energy security questions.

The key research focus is comparing energy supply delivery, recommendations for reliable and trouble-free transport and developing a technological infrastructure furthering the sustainable development of the Baltic States on the basis of their energy supply.

## **Introduction**

The rise of Russian oil has been the most influential new force in the world energy market since the Organization of Petroleum Exporting Countries (OPEC) consolidated power in the 1970s [1]. Russia holds more oil and gas than any country outside of OPEC and vies with Saudi Arabia for global leadership in oil production and export (Figure 1, 2).

Russia's economic interests regarding cooperation and development with the Baltic States also coincide with the fact that these countries have always been a traditional and receptive market for Russian energy resources, as well as a supplier of equipment and technology. Additionally, they may provide investment, which is important for modernizing the Russian energy sector, which has enormous potential for both foreign investments and for export. It is anticipated that this sector's investment needs will grow from EUR 400 billion to EUR 500 billion by 2020. Additionally, both the European Union and Russia have a mutual interest in improving energy security in Europe.

## **Geopolitical situation**

Currently, Russia exports 250 million tons of crude oil annually to Europe. Of this, 100 million tons goes through Belarus by way of the old *Druzhba* Soviet pipeline, 75 million through the Baltic pipeline system, and the others 75 million tons goes through the Black Sea and Ukraine. Until recently, the main problem facing the Baltic States was the construction of the Nord Stream gas pipeline on the bottom of the Baltic Sea. The Baltic States have reason to fear being cut off from access to resources and to be "out of the loop" regarding transit of Russian hydrocarbons. In addition, the Baltic

States fear a revival of a Moscow-Berlin-Paris axis as it will change the relative geopolitical position of the Baltic States. Bearing this in mind, it is no wonder that the Nord Stream gas pipeline project has met with such intense resistance from the Baltic States.

The Baltic republics are one of the most active defenders of the status quo regarding energy security of the EU, wherein any growth of Russian energy influence in Europe is considered a direct threat. This situation is quite justified. For full economic and political integration into EU, the Baltic States have had to wean themselves away from the energy infrastructure of the former USSR. Estonia has laid a cable connecting to Finland on a bottom of the Gulf of Finland for these purposes (the Estlink project). In the future, it is planned to connect the same cable to Latvia and Sweden and to connect Lithuania to the Polish electric grid. Latvia cooperated with Estonia and Finland in the construction of the underwater cable as to decrease energy dependence on Russia. This project has allowed Estonia and Latvia to connect to the power supply systems of Scandinavia and is the first step towards integration of the Baltic States' energy infrastructure with that of Western Europe.

### **Russian business expansion**

During the chaotic decade after the collapse of the USSR, Russia acquired a reputation as a difficult place to do business and, accordingly, many companies which initially rushed in to invest, later became extremely wary about Russia-specific risks. This was also compounded by falling oil prices. Media coverage of recent events in Russia has tended to focus on the hazards of investing in the oil and gas industry, but, despite this, we continue to see a high level of interest in new projects from international oil and gas firms.

Russian business expansion has begun lately. Russian energy companies do not just simply sell natural resources, but also acquire assets in international refining enterprises and invest money in new technologies. This process started in 1998, when LUKOIL bought Petrotel, a Romanian oil refinery. Since then, the volume of external investment by Russian companies has risen steeply. For example, the international refining capacity of LUKOIL (including two refineries in the USA and excluding Russian refining capacity) amounts to 16.7 million tons, as compared to 41.8 million tons in just Russia [4].

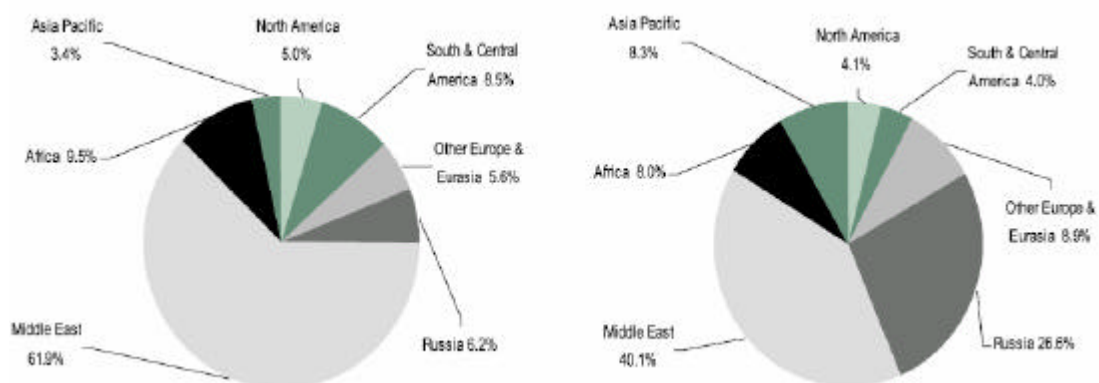
LUKOIL's international gasoline service stations network exceeds the total number of service stations in the Russia by a factor of greater than two. State energy companies are also trying to keep pace. Gazprom is a partner in trading and gas-distributing companies in Latvia, Lithuania, and Estonia (Table 1).

A more low-key foreign investor is the Swiss-based commodity trader, Glencore, who have established a strategic partnership with the rapidly growing Russneft, a company established in 2002 by the former president of Slavneft, Mikhail Gutseriev. [2] Energy transportation security is a critical condition for stable energy deliveries to the EU market. Hydrocarbon fuel is delivered from Russia to the EU by land and by sea. Cooperation in infrastructure development is of vital importance. Special attention is paid to the deployment of a network of pipes as an alternative to sea transport via the Baltic Sea. This is of special importance to the Baltic countries as a growth in the number of oil tankers on the Baltic Sea increases the risk of an accident and, consequently, an oil spill.



**Figure 1** An undersea electrical cable connects the Finnish city of Espoo with Tallinn, the capital of Estonia

It is crucial that the general rules governing energy trading are as predictable and transparent as, for instance, the rules of partnership and cooperation with the WTO or the rules on future agreements which facilitate and protect investments within the European Union. There are some major concerns regarding energy security.



**Figure 2** Share of worldwide oil and gas reserves (Source: BP's Statistical Review of World Energy, June 2006);

## Problems

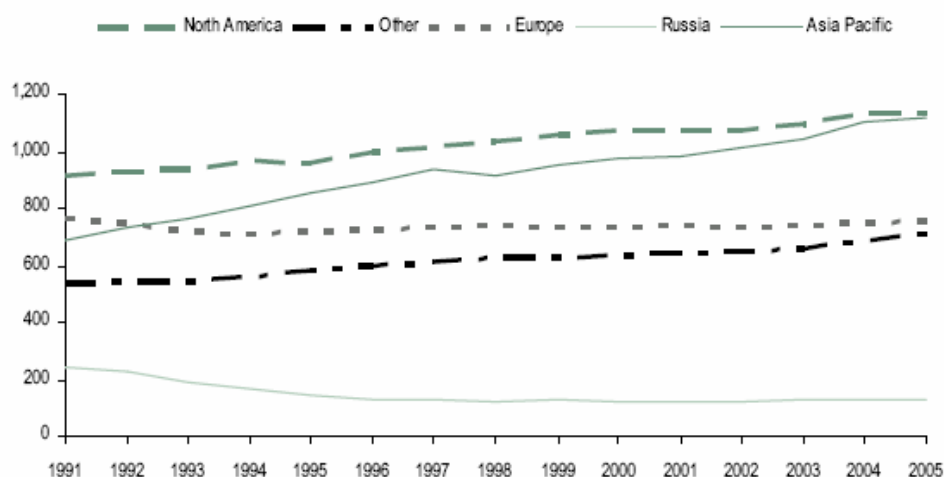
Russia's natural resources are part of its comparative economic advantage and state management will ensure that this advantage is exploited principally to support national goals.

The present Russian administration does not see markets, particularly in key natural resources, as intrinsically valuable. Instead, they are powerful tools to be managed by the right hands and directed for the right purposes. Moreover, there are

sectors that will not be left to the free market, like oil and gas transportation, ownership of subsurface minerals and, generally, the right to export natural resources from Russia.

The view of oil and gas as strategic resources under close state control not only set limits on Russian companies, it also defines the courses available to foreign firms seeking to enter the Russian market. The current administration plans to restrict foreign firms' participation in the Russian oil industry. Foreign firms that contributing to and lead remote, high-cost and technically complex projects will continue to be tolerated and even encouraged. Foreign ownership of equity stakes in Russian production companies is also allowed.

Few issues attract as much debate as Russian domestic gas prices. That they will rise is hardly the issue, rather the debate is how high and how soon they will do so. In May 2004, Russia vowed to increase its regulated industrial-use gas prices substantially, albeit gradually, as part of its World Trade Organization (WTO) accession negotiations with the EU. Specifically, Russia promised that gas prices for industrial users would be gradually increased from the 2004 average of around \$30 per million cubic meters (mcm) (according to Gazprom data) to between \$37-42/mcm by 2006 and to between \$49-57/mcm by 2010; levels that are described as in line with Russia's own energy strategy when the deal was struck on 21 May 2004.



**Figure 3** World oil and gas consumption, in million tons. (Source: BP's Statistical Review of World Energy, June 2006);

Gazprom's costs certainly spring to mind. In the absence of proper gas market reforms that would introduce appropriate market signals or more forceful regulation, Gazprom's costs will continue to rise unabated. Whatever the precise data, 2005 was clearly the fourth year of an increasing volume of export to the Baltic States after a marked decline in sales in the late 1990s (Table 1).

Russian gas is exported via pipelines to 14 states. Seven trunk lines go through Ukraine. The "gas conflict" with Ukraine in 2004 led to concerns among the Baltic countries regarding the stability of deliveries. The proposed solution was a bypass pipeline project under the Baltic Sea, with a capacity of 32 billion cubic meters per year and stretching for 1500 km. The final plans had the project's capacity at 15% greater than previously planned. The gas supply of the Baltic countries primarily depends on trunk East-West pipelines crossing the borders of the CIS countries.

	2001	2002	2003	2004	2005
<b>Lithuania</b>	2.2	2.4	2.9	2.9	2.8
<b>Estonia</b>	0.7	0.7	0.9	0.9	1.3
<b>Latvia</b>	1.1	1.1	1.2	1.2	1.4
<b>Finland</b>	4.6	4.6	5.1	5	4.5
<b>Germany</b>	32.6	31.5	35	40.9	39.9
<b>Poland</b>	7.5	7.1	7.4	6.3	7

**Table 1** Gazprom's 2001-2005 Baltic States Exports in billions of cubic meters, (Source: Gazprom, Gazexport, RPI FSU Oil and Gas Statistics Yearbook);

Currently, there is no serious alternative route for the gas deliveries and, thus, the political component of energy security is especially important, namely, agreement upon inter-country transit. Presently, such channels of communication are missing. A major factor fueling the instability is Russia's lack of desire to lose direct control over gas export. However, such a gas monopolist policy is dangerous for Russia as, in addition to gas, the Russian economy is strongly dependent on oil. If oil prices dip below USD 35 per barrel and gas exports are sharply reduced, it may mean a crisis for the Russian economy.

Another concern facing Russia is diversification of export transit routes. Currently, the largest among such projects is the Baltic Pipeline System (BPS), the Eastern Siberia – Pacific Ocean oil pipeline (ESPO) and the North-European gas pipeline (Nord Stream). The capacity of the BPS, which became operational in 2001, is 74 million tons. Due to worsening relations with Belarus, however, the government directed Transneft to develop proposals in order to increase the transfer capacity of the BPS to 120 million tons. The ESPO is being built with the purpose of creating a direct connection to China (30 million tons per year) as well as to the Primorie Region (50 million tons per year). Nord Stream will eventually allow for 55 billion cubic meters of gas per year go under the Baltic Sea to Germany and, further on, to the British Isles. These initiatives are the subject to criticism in the European Union.

In particular, Nord Stream concerns the Baltic States, as well as Eastern European countries which, like Latvia, have lost the possibility of Russian hydrocarbon being transported thorough their territory. This represents not only a loss of income for these countries, but also diminished political clout as well.

### **Prospects of energy dialog development between Russia and the Baltic States**

Real achievement in energy security will mean the structural integration of Russia into the world economic system. In order to attain this, Russia should meet some basic requirements, such as:

- integration of the Russian fuel and energy infrastructure into the world economy;
- coordinated control of tendencies of the world energy market, while keeping in mind the interests of energy exporter and importer;
- price stabilization on behalf of Russia energy producers;

- attracting investments in energy supply exploration projects, taking into account the interests of all the project participants;
- creation of a developed transport infrastructure;
- expanded use of innovative technologies for the exploration of oil and gas fields
- development and implementation of innovative technologies in state-owned oil and gas fields

Based on above, an increase in energy dialog between Russia and the Baltic States is necessary to solve the following basic problems:

### 1. Laying down a complex program for guaranteeing secure deliveries of Russian hydrocarbons to the Baltic States

No one in Russia doubts that the aim of the energy trade is not the maximization of export volume by a single energy carrier, but rather stable income and reinvestment derived from energy exports over the next 20-30 years. The initial position of Russia was simple: as the part of Europe, the Russian Federation bears a certain share of the responsibility for the energy security of the continent, if such responsibility does not infringe on Russia's own interests. While developing a complex program of energy delivery, Russia should emphasize the following:

- Additional deliveries of electric power should be accompanied by investments and technology transfer;
- special attention should be given to energy conservation as a way to reduce domestic consumption and free up resources for export;
- freedom of transit for all Russian energy carriers to the EU through Eastern Europe;
- expansion of energy deliveries should cover not only primary energy carriers, but also electric power, nuclear fuels, petrochemicals, goods that are exceptionally energy-intensive to manufacture (fertilizers, metals) and so on.

### 2. Mutual trade relations

The EU energy markets (gas and electric power) are opening up for competition after years of intense regulations, while the Russian market is still in the process of reforming. The Baltic States' market is also in the process of restructuring; new independent regulatory bodies have been created and conditions for cross-border trade have already been improved.

Russia has only began this process. The Russian power markets are interested in gaining from the experience of the Baltic States in such areas as attracting investments, industrial cooperation creation of joint ventures for example, fair pricing and systems of tariffs.

### 3. Joint participation in infrastructure projects

Opportunities for technology transfer from the Baltic States to Russia in the field of an oil and gas production, oil refining, clean coal, and power efficiency are especially great. The Baltic States and Russia could implement common energy conservation programs with the participation of energy companies, industrial enterprises, and consumers. Russia and the Baltic States have the chance to coordinate initiatives to search for new suppliers to satisfy the energy needs of the EU and, additionally, find new markets for Russian products. Both the Baltic States and the Russian Federation are in agreement that investment decisions should be left to market factors. Tax and environmental policy will structured in such a manner as to stimulate increase power efficient and capital investments in technology. Russia, however, sees the role of the

government differently when it comes to attracting significant domestic, as well as foreign investments.

In an environment of scarce investment resources and high costs to develop new deposits, Russia, through Russian companies, is investigating the possibility of engaging funds from foreign companies to implement certain large and complex projects.

#### 4. Mutually acceptable agreements for long-term energy supplies

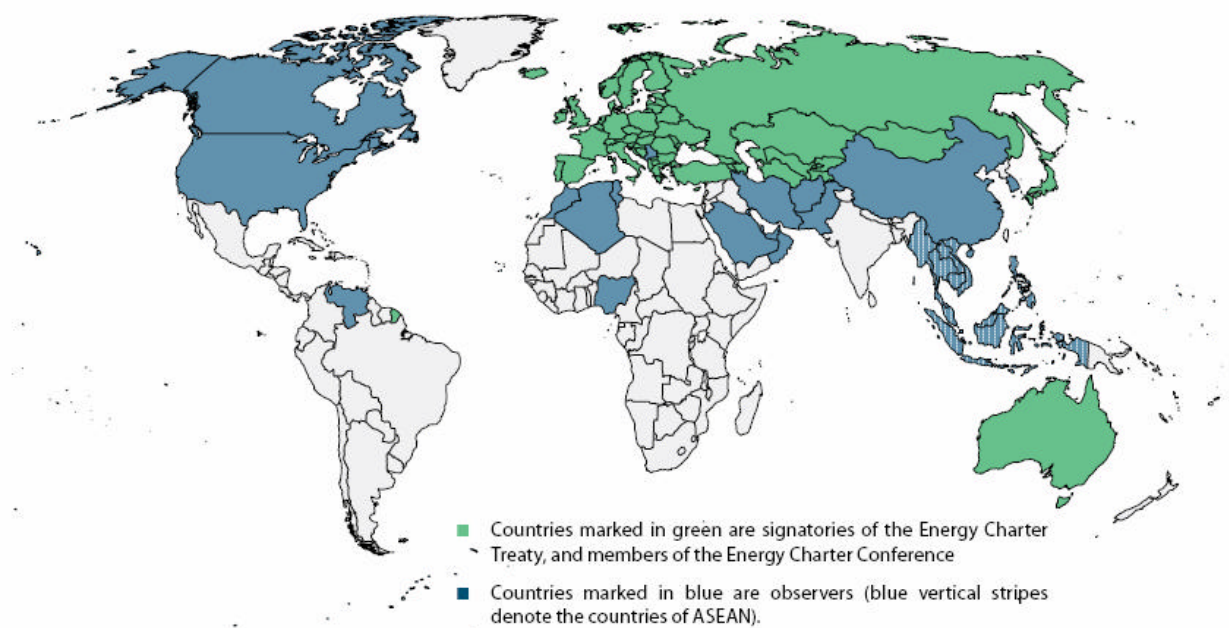
A key issue of the unfolding dialogue on energy is the invariability of terms and conditions of effective long-term contracts and the possibilities to enter into long-term contracts in the future with conditions that are favorable to Russia and that will not be affected by the energy market liberalization processes that are currently under way in Europe.

Long-term export contracts may as well be considered as a guarantee of funds repayment upon investment in capital-intensive projects, both in terms of deposit development and transportation infrastructure development. The contract participants note that long-term export contracts on the conditions of "take or pay" play an important role and will maintain this role in ensuring stable and reliable natural gas supplies to the united European market. Russia believes that the expected decision of the EU should not affect the currently effective long-term contracts and result in a deterioration of the delivery conditions for the already contracted supplies. Another advantage of long-term export contracts is that they ensure a stable solvent sales market for Russian suppliers in the conditions of increasing competition in West Europe. On the other hand, for western consumers, long-term gas supply contracts are a guarantee of reliable supplies, especially if we are to factor in the growth trend of gas consumption in the region in an environment of increasing dependence on imports.

#### 5. Mutual diversification of Russia and the Baltic States deliveries.

On behalf of both parties, it might be necessary to shift the long-term focus from interdependence to mutual diversification. For example, in the Baltic States, it might be necessary, in the near future, to find other sources of natural gas, considering that Russia can hardly satisfy a constantly increasing demand for natural gas.

On the other hand, Russia does not wish to rely exclusively on one export market for natural gas in the long-term and it is clear that they will aspire to diversify exports with the purpose delivering significant volumes of natural gas to the Far East. Both for the Baltic States and for Russia, it is not only an economic question, but also a question of energy security. Mutual diversification of both parties of this sort could be used as a base for further collaboration between Baltic States and Russia. Baltic companies could participate, with Russia, in power resources deliveries projects to the new markets; joint ventures could provide the technical solutions to lower expenses and to reduce harmful impact on the environment. In this respect, the purposes of power security and mutual diversification are quite compatible. It is also vital that any new agreements will build on, and not contradict, existing international agreements. One massive question is Russia's ratification of the Energy charter, which will provide Russian companies non-discriminatory treatment in the Europe and in other export markets.



**Figure 4** Energy Charter in the world. Country Reviews. (Source: Energy Charter Secretariat, March 2007);

These mechanisms can be involved for the protection of the Russian exporters' interests and the creation of equal conditions for entering the high-yielding markets of the European Union. Additionally, the ratification of the Energy Charter will open Russian roads to connection to the Transit Report (being in the final stages of approval). This contract lays out, in international legal terms, the "game rules" for cross-border transit of energy resources.

Use of this mechanism will allow for effectively solving of the problem of physically protecting Russian gas in transit to third-party countries.

For example, a chronic several years ago problems with illegal selection of gas from the Ukrainian export gas pipelines would be a question not mutual relations with Ukraine (being a member of the Energy Charter), and would be solved on a multipartite principle under the aegis of the Energy Charter Treaty (ETC) or in some sort of international jurisdiction. The Transit Report also guarantees the supplier of moderate transit capacities on non-discrimination principles and application of objectively proved and fair tariffs.

## Conclusion

In conclusion, it should be mentioned that the Russian energy sector needs investment. Russian economic interests lie in energy cooperation with the Baltic States, taking into account the strategic and receptive energy market of the EU and the potential import of equipment and new technologies. The EU has great potential, both as an energy market, and a source of investment for modernization of the Russian energy industry. Russia has a plan to negotiate favorable terms for energy suppliers, to establish a mutually advantageous cool down period in the area of production and transportation of energy in Western Europe, and also to pride on the place on the Baltic States energy market.



Hindrance to integration, reluctance to ratify the Energy Charter, monopolization of the industry and control over export prices, alongside with protectionist measures on the part of Russia create serious obstacles on the way to the introduction of market mechanisms in the industry and to further increase investments in the extraction sector. It is not safe to overcome these obstacles. It is to be done on a step-by-step basis, beginning from the external environment, which is currently involved in transitioning to market principles in terms of pricing.

### **List of Acronyms**

EU	European Union
OPEC	Organization of Petroleum Exporting Countries

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