Peter Thomson Response

Russia has historically dominated the energy supply equation in the countries of Eastern Europe and the former Soviet Union. During the Soviet era, energy distribution within the Soviet Union and to member states of the Council for Mutual Economic Assistance was controlled by Moscow. While the break-up of the Soviet Union offered the opportunity for importing countries to secure energy supplies from alternative locations, most of the countries of Eastern Europe and the former Soviet Union (FSU) remain heavily dependent on Russia for primary energy supplies.

Russia has historically used its energy dominance as a political instrument and continues to do so today. However, during the transition period that began over 20 years ago, Russia has faced and continues to face a number of challenges to its energy role.

Following the break-up of the Soviet Union, Russia experienced a roller-coaster ride in redefining the role of energy in the new geopolitical environment that emerged. The mid 1990s saw an aggressive move towards privatization in the oil sector in Russia with the establishment of vertically integrated companies and the introduction of loans for shares schemes that ultimately allowed a number of Russian players to acquire controlling interests in the oil sector at very low cost. At the same time, international companies were actively pursuing opportunities to become engaged in Russia. This whole thrust, however, ran completely counter to the historic oversight role of the State.

In 1999, the same year he became Prime Minister, Vladimir Putin authored an article in which he argued that, given the economic and strategic importance of Russia’s oil and gas resources, these assets should be under the aegis, if not direct control of the State. After Putin became President, Russia embarked on a program of partial re-nationalization of the petroleum sector highlighted by the break-up of Yukos and the reassignment of its assets to the State owned/controlled companies Rosneft and Gazprom. This effectively tempered the threat of a reduction in State control over the energy sector.

Russia is a major player in the European gas sector supplying over 20% of Western Europe’s gas requirements. With the break-up of the Soviet Union, Russia’s main vulnerability in supplying gas to Europe has been the fact that it now has to negotiate transit arrangements through such FSU countries as Ukraine, Belarus and Moldova. Russia’s initial response was to try to gain control of the transit systems. While it was initially successful in Moldova it met resistance in Belarus and Ukraine (although that has been declining). As a result, Russia initiated the option of by-passing the transit countries.
The first evidence of this approach came with construction of the Blue Stream pipeline across the Black Sea to Turkey, by-passing Georgia. The Nord Stream pipeline which was inaugurated in November 2011 by-passes Belarus and the proposed South Stream project would by-pass Ukraine. In all cases the use of existing systems would make greater economic sense but would constrain Russia’s level of control over gas deliveries.

While the Russian government has been prepared to make significant investments to maintain a high level of direct control over its energy sector, it has not been investing adequately to support its long term production outlook. Investments in the gas sector, in particular, are well below the levels required to maintain production levels over the longer term, let alone increase them to meet projected higher demand. As a result, Russia faces the very real prospect of seeing gas production start to decline before 2020. Russia’s initial response to this will likely be to try to purchase additional supplies from Central Asia (essentially Turkmenistan). However, Turkmenistan is looking to China as a primary outlet for its gas and will likely not be able to increase significantly gas deliveries to Russia. (China is now a competitor for energy supplies in Russia’s back yard). Russia’s likely follow up action will be to squeeze domestic demand which could lead to the substitution of coal for natural gas for power generation.

Under-investment in the energy sector is not unique to Russia. The region as a whole needs to make significant investments if it is to be able to cover its anticipated energy needs. Investments on the order of $3.3 trillion – or about 3% of cumulative GDP for the region as a whole will be required over the next 20 years. Given the uncertain economic and financial outlook in the region, there is a very real prospect that the full level of required investment will not materialize raising the prospect of energy shortages that will impact economic growth and the substitution of domestic sources of energy such as coal for less polluting imported sources of energy such as gas.

The fastest way for the region to improve its energy supply/demand balance is through energy efficiency investments. The level of energy intensity in the region on average is about five times that of Western Europe - so there is huge scope for energy savings. However, the major constraint to investment in energy efficiency is the lack of appropriate incentives – in particular the use of inadequate tariffs that do not reflect energy costs. About half of the countries in the region have electricity tariffs that are not sufficient to cover the long run marginal cost of generation. This is very much a legacy of the Soviet era and what the past 20 years has shown is that it generally takes a crisis to precipitate action to overcome this Soviet mind-set. Energy security is an increasing concern among many of the importing countries and the impending energy crunch may well precipitate such a crisis.

Given underlying energy security concerns, countries will seek the most immediate and affordable solutions to meet their energy needs. Increased investment in energy efficiency is, therefore, in prospect, but so too is increased use of coal. There will also be reluctance to close
down aging facilities (including nuclear plants) in the absence of replacement supplies. Climate change concerns will play second fiddle to energy security concerns.