



**Statement before the Senate Foreign Relations
Subcommittee on European Affairs**

***“RENEWED FOCUS ON EUROPEAN
ENERGY SECURITY”***

A Statement by

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July 8, 2014

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Chairman Murphy, Ranking Member Johnson, Members of the Committee:

It is an honor for me to return to the subcommittee to testify on European energy security and the impact of the ongoing crisis in Ukraine.

When it comes to the question of energy security for Europe, we are, of course, talking primarily about natural gas supply. It is interesting to ponder why, when Europe is more dependent on oil imports than it is on gas imports. In the past year, there were major oil supply interruptions from unrest in Libya, sanctions against Iran, and minor disruptions from Syria and South Sudan. On the other hand, there has been no gas supply cutoff to Europe even with the Ukraine crisis caused by Russia's actions. Russia's share of the European oil market is about the same as it is with gas. Yet the level of anxiety in Europe is much higher with gas than with oil. Why?

The answers go beyond the different nature of oil and gas markets and the ease that crude oil and petroleum products can be traded and transported as compared to natural gas. The root causes are related to incomplete market integration in Europe when it comes to gas and electricity, which fails to take full advantage of economies of scale provided by a 500-million consumer market.

Europe has not adapted to changes in the global gas market or adapted to new technologies. Its gas markets have been dominated until recently by long-term contracts at fixed volumes with prices indexed to oil. Suppliers have restricted competition and the free flow of gas with destination clauses and control of pipelines. Consequently, Europe does not enjoy gas-on-gas competition the way we do in the United States after the federal government deregulated natural gas in 1978, which incidentally was a major factor enabling our shale gas revolution.

Many of these anti-competitive business practices were supported not only by major foreign suppliers such as Gazprom of Russia, but also by incumbent European gas companies that control distribution infrastructure in their home countries and were all too happy to pass on the higher cost and economic pain of an inflexible system to gas consumers. Consequently, European gas and electricity distribution infrastructure and markets are not as well connected as one might suppose in a common market.

So what can the United States do to help our European allies and trading partners? Here I have to debunk some commonly held notions in Washington.

The first point that has to be made is we have already done a lot indirectly through the shale gas boom. Since the United States no longer imports liquefied natural gas (LNG) in increasing volumes as we were expected to do, these supplies from liquefaction projects previously targeted for the U.S. market became available for Western Europe. Despite initial denial of the lasting nature of the shale gas phenomenon, Gazprom was forced to meet the market by adjusting *downward* all its major supply contracts under more flexible pricing. As a result, European imports of Russian gas increased by 13% last

year, half of which transits through Ukraine. Western European LNG import facilities are currently operating at very low utilization rates (around 25%). Even if U.S. LNG exports were available today, they would not be imported by Western Europe, but by East Asia where spot gas prices are about double European prices.

When the United States begins to export major volumes of LNG in a few years, its benefit to Europe lies not in the quantities it might receive, but in future price formulation in global gas markets. We may finally see gas-on-gas competition outside of North America, with gas prices no longer rising and falling with oil prices, when global market prices converge after adjusting for LNG transportation cost differential.

The tremendous competitive advantage the shale gas revolution has provided the U.S. economy, with lower gas and electricity prices coupled with reduced greenhouse gas emissions, has also caused European capitals and the European Union (EU) to reexamine their energy policies, with renewed efforts for further market liberalization, enforcement of competition rules, and rethink on the use of domestic energy sources. (It is not without irony that some advocate strongly for exporting U.S. LNG to our European allies when some of these countries, such as France and Germany, effectively ban hydraulic fracturing.) However, it will take years before significant results can be achieved.

In the meantime, the crisis in Ukraine, caused by Russia, presents a clear and present danger for European energy security. The risks are borne disproportionately by Central and Eastern European countries, as I testified before this subcommittee in April, since they rely on Russia for almost all of their gas imports, much of which transits through Ukraine. I also testified before this subcommittee two years ago on the vulnerability Ukraine's weak and corrupt energy sector creates for itself and its neighbors. I wish I could be more optimistic today than I was in those two other occasions.

The previous Ukrainian government left the current government with mounting gas debt to Russia, which predates President Yanukovich's public change of heart on the signing of the Association Agreement with Europe last November. The debt issue and the failure to agree to new gas prices led to the cutoff of Russian gas supply to Ukraine on June 16. Ukraine depends on Russia normally for 60% of its gas supply and is the major transit corridor for Russian gas exports to Europe. In neither case are there ready substitutes.

If the already-delayed injection of gas into strategically-located western Ukrainian storage facilities does not begin soon, Ukraine will run out of gas before the start of winter. If nothing changes, the Ukrainian government would be left with a choice of either letting its own population freeze or taking gas from Russia destined for European markets for its own use.

If one assumes that Russia's intent, unless met with stiff resistance, is to further destabilize Ukraine and to prove to Europe that Ukraine is an unreliable transit partner, then it is in Russia's interest to prolong current negotiations. To date, European mediation has led to no results other than agreement on the date and place for the next round of negotiations. The European gas market is surprisingly complacent about the

situation. Spot gas prices have dropped significantly and, although gas storage capacity has risen, actual storage is not as high as it could be. The risk of miscalculation is high.

Meanwhile Russia is pushing its South Stream gas pipeline project, which would bypass Ukraine altogether, as an alternative supply route to Europe. Only yesterday Russian foreign minister Lavrov was in Sofia urging Bulgaria to start construction of its segment of South Stream against EU objection. (Incidentally Bulgaria also bans shale gas exploration.) Long ago Russia has signed up the west Balkan countries along the route to support South Stream; more recently Austria came onboard formally. Gazprom's partners in South Stream include major Italian, German and French energy companies. Partners such as the Western-supported Southern Gas Corridor projects of Trans-Anatolian pipeline (TANAP) and Trans-Adriatic pipeline (TAP) have not progressed as fast as was hoped after contract signings at the end of last year. For example, the landing spot in Italy has not yet been agreed.

As someone more comfortable with commercial negotiations, I instinctively question economic negotiations brokered by political leaders eager to head to the press conference after a couple of hours of unproductive discussions. I will know the negotiation has become serious when negotiators stop talking to the press. Some of the proposals on gas from European politicians, such as an energy union with a single gas purchaser (Polish prime minister Tusk) and a uniform gas price for Europe (EU energy commissioner Oettinger) make no economic or commercial sense and are, I hope, merely political posturing and not serious policy proposals.

Long-term sustainable economic transactions cannot be based mainly on political conditions, which tend to change as we discovered with the Russia-Ukraine gas deals of January 2006, January 2009, April 2010, and last November. Raising matters to the highest political level as Europe has done only invites Russia to make political demands, such as accommodation of its occupation of Crimea, restrictions on Kyiv's actions in southeastern Ukraine, and a stop to further Western economic sanctions in response to Russian aggression against Ukraine. These negotiations need to be handled in a professional manner yet to be displayed by any side.

The only real solution to the crisis in Ukraine is to strengthen Ukraine itself. It has been more than four months since the acting Ukrainian government came into power after the collapse of the previous government. President Poroshenko was inaugurated almost exactly a month ago. He, Prime Minister Yatsenyuk, Energy Minister Prodan all observed first-hand and up-close the blunders made by previous Ukrainian governments on energy policy by perpetuating and expanding the corrupt system. Business-as-usual is no longer an option and cannot be accepted, especially by the Ukrainian people after the sacrifices of EuroMaidan which they continue to make. Policy rhetoric alone is insufficient. Concrete action is required and we have seen precious little so far. Some initial steps, such as the emergency energy legislation proposed by the government and passed by the Ukrainian parliament (Rada) in its first reading last Friday, appear to be against market principles and require more professional scrutiny.

What needs to be done for energy sector reform in Ukraine is well known, especially in natural gas. Many studies have been commissioned in the past decade by Ukrainian governments and international bodies, and have gathered dust. What have been missing are the political will and the professional and financial capacity to execute reforms in an orderly and systematic way. This is particularly important in pricing reform not only at the consumer level as demanded by the International Monetary Fund (IMF), but also at the producer level in order to encourage investments in domestic production. Also crucial are a truly independent energy regulatory commission and transparent, modern licensing procedures to eliminate graft.

Reform depends foremost on Ukrainian leaders. True reformers deserve and require concerted Western assistance if they are to succeed. More than twenty years of neglect has left Ukraine with meager financial and human resources to fundamentally reform its energy sector, which is so critical to its survival and to stability in the region. As long as Ukraine is weak, it is an open invitation for Russian opportunism and aggression, and a constant source of instability in the heart of Europe.

The West took its eye off the ball after the Orange Revolution in 2004 and never gave President Yushchenko and his various cabinets the tough love they needed. After 2010, we appeared to avert our eyes capriciously with President Yanukovich and his barely-disguised industrial-strength corruption. Neither Ukraine nor the West will have another chance better than the opportunity created by the current crisis. The situation cries out for American leadership, working closely with Europe and the donor-community, by injecting needed resources with strict conditionality on the provision of assistance. Similar to Ukraine, our own rhetoric must also be informed by sound analysis and followed by concrete actions, not wishful thinking as we have done too many times with Ukraine and its energy sector in the past.