

Ukraine, Europe and Energy

PROFESSOR DIETER HELM, UNIVERSITY OF OXFORD

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After a short pause, the borders of east and southeast Europe are again in flux, as they have been on and off since the early Russian people established Kiev as their capital. Crimea was annexed by Catherine the Great. The British and others fought the Crimean War in the nineteenth century and Russia's imperial expansion towards the Balkans helped to trigger the First World War. Stalin created the greatest Russian empire – the Soviet Union – which Gorbachev lost. Putin regards the loss of the Soviet Union as the greatest political disaster of the twentieth century. The great game is on again.

Putin has never accepted that Ukraine is a proper country. It is the Russian backyard, and after what he sees as the shame of Gorbachev's and Yeltsin's surrenders, the idea that Ukraine could aspire to eventually join the EU and NATO is anathema. He was never going to let this happen.

Ukraine has been on Putin's radar at least since its Orange Revolution in 2004. Determined to hold the line, Putin used Gazprom to try to isolate Ukraine and pressurise its leadership to a more accommodating position. The Orange leadership was challenged with higher gas prices and threatened over its debts. Twice – in 2006 and 2009 – the gas was cut off.

But Putin had a bigger plan – to bypass Ukraine as a route to Europe for Russian gas. The Nord Stream pipeline between Russia and Germany – bypassing and isolating Poland and the Baltic countries

– was one element, and South Stream through the Black Sea was to be the second. He bought political support too, especially from Germany and its core energy companies.

This time around, Putin was initially caught on the hop. He did not anticipate the latest Ukrainian revolution, but he acted fast, annexing Crimea and destabilising eastern Ukraine, with a view to federating the country and effectively breaking it up.

The Europeans have huffed and puffed, but in reality acquiesced, with Merkel leading the way in heading off serious sanctions. The European summit in March did agree to task the European Commission with putting together a plan to wean Europe off Russian gas, but the reality is that Europe will be buying Russian gas for a long time to come.

The European Alternatives to Gas

What the latest episode in this long running Ukrainian saga has done is to encourage Europe to pursue other sources of gas, and to further diversify away from it. The possible alternative supplies are numerous, political and difficult. Europe is surrounded by gas. There is the North Sea, and especially Norway. There are the north African states, notably the massive resource base in Algeria, and significant reserves in Libya. Further afield there is abundant gas in the Caspian states, northern Iran and northern Iraq. There is even gas in Ukraine.

Alongside the obvious political instabilities in most of these countries, there is the inconvenient fact that many of these supplies would have to go through Turkey. Europe has not covered itself in glory and goodwill in its negotiations on Turkey's membership of the EU. Then there is the tricky question of Europe offering comfort and security to these potential suppliers if they break ranks with Russia. Georgia found out the consequences when bits of its territory were annexed by Russia in 2008.

Moving away from gas is something Europe has in fact been doing on a significant scale for the last few years. But not in ways that might be expected. Europe has actually been moving from gas to coal – and in Germany's case also from nuclear to coal. There has been a large-scale dash-for-coal in electricity generation – and in Germany's case to coal mining too. Germany is now 45 per cent dependent on coal for electricity generation, and Britain has gone up from 28 per cent to nearly 40 per cent. Germany has been quietly adding new coal power stations, as has the Netherlands and a number of countries to the east.

It is about the dirtiest strategy imaginable from a climate change perspective; it is brown and black, not green. The result has been bad for emissions and air quality and both Germany and Britain now have rising emissions.

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Renewables Were Meant to Step Up

This was not what was planned. The aim was to wean Europe off coal towards first gas and then renewables by hiking up the price of carbon. The Europeans expected this to happen through the EU Emissions Trading Scheme which was supposed to provide a rising, stable and gradually long-term price. Instead, it produced a low, short-term and volatile price, which made little difference to anything other than the profits of traders and some of the incumbents. Crucially it did not encourage any switching from coal to gas.

The falling gas demand was exacerbated by the great economic crisis, the recessions and then the anaemic economic growth. Energy demand turned out to be much lower than expected and hence less electricity was required. Taken together, the result is that Europe is littered with mothballed gas plants, several of them almost new. Even Gazprom has felt the impact.

None of this was in the European script. On the contrary, it was renewables that were supposed to replace coal and gas. It is true that they have been added on an impressive scale in a number of countries, again including Germany. They have further cut into the gas burn and because they have very low marginal costs have made investment in new gas plants all but impossible. Renewables force

everything else off the system when the wind blows and the sun shines. It cannot be certain therefore when, or even if, new gas plants will be needed, and this undermines expected revenue forecasts.

The European gas story is very different from that experienced in the US. The US has switched from coal to gas, where shale gas is abundant and about a third of the European price. US emissions have been falling, whilst Europe's are now rising in key countries. Europe is therefore not in a good place confronted as it is with two key challenges: how to respond to the bear hug of Russian gas, even at lower demand levels; and how to address its self-proclaimed role as the global leader on climate change. Europe now has very expensive energy, rising emissions and a serious security of supply problem to the east.

The European Response

If Putin decides to pull the plug on Ukrainian gas supplies, Europe is not much better placed to respond now than it was in 2006 and 2009. Now that spring is here, and gas stores are very high after a mild winter, there are some months to think about what to do when winter comes again. There are short-term measures that can be taken, such as encouraging better connections and reverse flows in pipelines. It can try diplomacy too, and help pay off Ukraine's debts to Russia for the – now inflated – gas prices that Gazprom is demanding.

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Not everyone will suffer from such an interruption. Germany has its own direct pipeline to Russia – Nord Stream. It can carry on appeasing Putin without too much to worry about at home. For the front line states, life is not so rosy. There are Russian minorities in the small Baltic States, and these rely almost completely on Russian gas. Poland has exposure too, though its solution has been coal, which provides over 90 per cent of its electricity. For these countries nuclear has considerable appeal as an alternative, but renewables do not come close to matching the sheer scale of their energy dependence.

There are solutions to Europe's energy problems. It is not difficult to work out how it could hold its own against Putin and Gazprom. Russia needs the money – more than 70 per cent of its exports are energy and more than 50 per cent of the government's revenue comes from oil and gas. It is a fossil fuel economy. Europe could confront Russia's monopoly of supply with a monopoly of demand. It could band together to buy its gas jointly through a central agency, linking imports and insisting on a single common price. Gazprom's 'divide and rule' and its price discrimination could be curtailed.

Whether Europe has the courage to stand up to Russia and to show real solidarity with the eastern member states remains to be seen. Germany's special energy relationship with Russia is a major roadblock and, most likely, Europe will continue to do little.

Those in the east will be left to face the music. Putin knows Europe lacks the political will to stand up to him. So the great game will go on. The borders established when the Soviet Union collapsed in 1989 and the Russian dominance of Eastern Europe ended will remain fluid. For Russia, there is everything to play for. For Eastern Europe, there is much to fear.



Dieter Helm, Professor of Energy Policy, University of Oxford & Fellow in Economics, New College, Oxford
Dieter Helm is an economist, specialising in utilities, infrastructure, regulation and the environment, and concentrates on the energy, water and transport sectors in Britain and Europe

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