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Progress in the preparations for building South Stream

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Russia's Gazprom and the state-controlled Serbian and Hungarian energy companies on 29 and 31 October passed final investment decisions concerning the construction of the Serbian and Hungarian sections of the South Stream gas pipeline. Bulgaria, whose consent is necessary for the investment to be implemented, has promised to pass a similar decision on 9 November.Thus the stage of creating the formal and legal framework of Russia's largest investment in the energy sector in Central and South-Eastern Europe is coming to an end. This progress is proof of Russia's determination, which has been pushing through the project despite serious doubts about its economic feasibility. The countries through which the planned pipeline route runs also display a positive approach to the project. They see it both as a strategic investment which will ensure the diversification of their gas supply routes and as a tool for obtaining concessions and economic benefits from Russia. However, the progress linked to issuing the final investment decisions still does not presume that the investment will be implemented. Other essential elements include the assessment of the investment's environmental impact and ensuring funding for this extremely expensive project.

Preparation progress

The South Stream project envisages building a gas pipeline with a capacity of 63 billion m^3 along the Black Sea bed, which will transport gas to Europe via the two pipes: the northern (Bulgaria, Serbia, Hungary and Austria with branches going to Croatia and Slovenia) and the southern (Bulgaria, Greece and Italy). The project, being Gazprom's flagship investment, was initiated in 2007. Since then, Russia has signed intergovernmental agreements with the states located along the pipeline's route. Furthermore, consent from Turkey has been obtained to lay the pipeline within its exclusive economic zone. Companies in charge of preparation of individual sections of the gas pipeline have been established: the seabed section (registered in Switzerland, shareholders: Gazprom, ENI, Winthershall and EDF) and the land sections in individual countries. The companies in charge of the land sections are registered as entities created as equal partners by Gazprom and state-controlled energy companies (each holding 50% of the shares). One exception is the company responsible for building the gas pipeline in Serbia, which is not an EU member state, where Gazprom gained the control block (51% of the shares), and the company was registered in Switzerland. None of the firms involved in the project from the transit countries has given information about

feasibility studies. However, as final investment decisions were signed in Hungary and Serbia, details concerning the construction of the national sections were provided (see map).

The approach of Serbia, Hungary and Bulgaria towards South Stream

The friendly approach from Serbia, Hungary and Bulgaria to this investment is based on similar factors. The construction of South Stream will not mean a diversification of gas supply sources for any of these countries. However, it will offer them a chance of diversifying their gas supply routes. This is important especially in view of the fact that no clear progress has been seen in the implementation of the other projects, including the Nabucco gas pipeline. These countries have also declared that the South Stream project does not rule out their participation in other projects aimed at diversifying supply sources. The two EU member states, especially Bulgaria, have emphasised that the project is to be covered by EU energy legislation. This is expected to prevent this route from being used to strengthen Gazprom's position as a monopoly supplier. At the same time, the countries through which South Stream will run are interested in strengthening their role in regional gas transport and would not wish to lose this opportunity, which could otherwise be offered to their neighbours. It was not by accident that Moscow initiated talks with the neighbouring countries during the negotiations, thus suggesting that the route of the gas pipeline could be shifted (for example from Bulgaria to Romania and from Hungary to Croatia).

Other important motivations, apart from energy issues, include economic interests seen from a broader perspective. This investment is expected to provide a major stimulus for boosting economic growth and subsequently to bring profits from transit charges. These countries also want to use their participation in the construction of South Stream as a means of obtaining specific concessions from Russia, including more favourable terms of the long-term gas contracts or preferential access for their domestic companies to the Russian market.

For **Serbia** the implementation of the South Stream project currently offers the only real chance for diversifying its gas supply routes. This country is completely dependent on one supply route of Russian gas: via Ukraine and Hungary. Given the present economic situation, Serbian companies do not have enough funds to launch diversification projects by themselves (for example, system interconnectors with Romania and Bulgaria). In the case of South Stream, Serbia hopes that it will be primarily the Russian partner who will take up the burden of ensuring funds. The other large transport infrastructure projects (e.g. Nabucco) are not running through Serbian territory, and their possible implementation would additionally entrench its peripheral situation on the map of supply routes, while South Stream in the long term will allow Serbia to become an important Balkan gas transport hub, which will enable gas supplies to Bosnia and Herzegovina, Croatia, Montenegro and Macedonia. It was certainly not a coincidence that Serbia's consent to South Stream was given at the time when framework agreements on a future gas contract were signed.

However, it is difficult to evaluate at the present stage how favourable the conditions offered for Serbia are (no details of this contract have been revealed).

Hungary has backed South Stream due to the need to diversify its gas supply routes. At present approximately 80% of the gas it imports comes via Ukraine (the remaining part is brought from Austria). However, additional goals in the country's economic policy are equally significant. Hungary hopes for safer and cheaper gas supplies after its present contract has expired (from 2015). One cannot rule out the notion that promises of securing access for Hungarian companies to the Russian market have been an element of the agreement with Gazprom. In September, the Hungarian Ministry of Economy signed a framework agreement concerning the participation of Hungarian firms in investments in the energy sector in the Northern Caucasus worth 1 billion euros with the Russian company Minneftegazstroi. Hungary's negotiating position in talks with Russia could be weakened due to speculations about the possible shifting of the gas pipeline's route to Croatia. The Hungarian government's approach to South Stream at the same time fits in the policy of strengthening the state-controlled power and energy group MVM, which in August this year took over the shares in the company responsible for building the Hungarian section of South Stream from the state-controlled bank MFB. Over the past few months, MVM has become the key executor of the government's energy policy. For example, it has become engaged in the implementation of AGRI, the gas interconnector project with Slovakia, and in the project of establishing a national gas exchange (MVM's participation in the LNG terminal in Croatia is also being considered).

South Stream will also allow **Bulgaria** to have its supply routes diversified, since currently 100% of its gas imports are supplied using a single route, running through Ukraine and Romania. At the same time, Bulgaria has the strongest negotiating position in dealings with Russia, given its geographical location, which is of key significance for the South Stream project. For this reason, the greatest amount of tension is present in Bulgarian-Russian negotiations. For instance, Sofia was the last to establish a project company. Bulgaria wants first of all to be given favourable gas supply conditions, as its gas contracts will have expired at the end of 2012. The government has also made efforts to properly protect its interests in the South Stream project – maintaining the minimum possible financial contribution and at the same time ensuring the construction of a completely new transport infrastructure. Sofia has not agreed to existing Bulgarian transit gas pipelines being incorporated in the project, fearing that it could lose control of its own transport network. Speculation that Bulgaria could make its consent for the construction of South Stream dependent on resolving problems linked to other Russian-Bulgarian energy projects have appeared during the negotiations. Bulgaria wants Russia's Atomstroyexport to withdraw its claims worth 1 billion euros concerning Bulgaria's National Electric Company due to abandonment of the plans to build the nuclear power plant in Belene. However, Bulgaria is unlikely to block South Stream for this reason, because signing favourable gas supply contracts with Russia seems to be a top priority.

Conclusions

The fact that Serbia and Hungary have issued final investment decisions and that similar decisions are expected in November from Bulgaria and Slovenia can be recognised as the culmination of the process of building the formal and legal framework for the implementation of this investment. The South Stream project is being carried out in line with Russia's timetable. Nevertheless, some investment decisions, environmental permits and precise determination of the sources of funds are still missing. Central and South-Eastern European countries will have a limited influence on the implementation of this project. The political elites in these countries generally agree about the benefits this investment offers (major controversies have been seen only in Bulgaria). As the investment moves to further stages, these countries will certainly make more efforts to gain additional benefits, while blocking the project is rather unlikely. They will not withdraw their support for the implementation of other projects aimed at diversifying gas supply sources, such as Nabucco West, importing liquefied natural gas via the Black Sea (AGRI) or gas interconnectors. However, it cannot be ruled out that as further progress in the implementation of South Stream is made, their determination in supporting these projects will weaken.

Map

Existing and planned gas transport infrastructure in the region

