

The unwanted gas pipeline: Russia has halted the construction of South Stream

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During his visit to Turkey on 1 December, President Vladimir Putin announced that Russia had been forced to halt construction of the South Stream gas pipeline due to the unconstructive stance taken by the European Commission and the passiveness of the Bulgarian government. Alexey Miller, the CEO of the Russian gas company Gazprom, said that this project was closed and would not be reactivated. During the visit, Gazprom and the Turkish energy company Botas signed a Memorandum of Understanding envisaging the construction of a new gas pipeline running through the Black Sea that would make it possible for supplies to be delivered to both the Turkish market and Southern European countries. President Putin announced that Russia would become more engaged in developing LNG projects and would increase its share in non-European gas markets.

Most likely, the main reason behind Russia's decision is Gazprom's financial problems, which are partly a result of the sanctions. These prevent the investment from being implemented (the costs of the construction of the pipeline have risen by nearly 40%; and the companies which were going to participate in the construction have problems obtaining investment loans). Furthermore, the European Commission expressed doubt as to whether the agreements Russia had signed with the countries through which the pipeline was to run were in compliance with EU law and Bulgaria suspended work on the project in June this year; these two facts bore a strong impact on Russia's decision. On the one hand, the withdrawal from South Stream is a painful failure of Russia's energy policy. Yet, on the other hand, while announcing its decision to withdraw from the construction of South Stream, Russia hopes that this will give rise to greater dissatisfaction in the countries which support this project (Hungary, Austria and Serbia), and that the voices calling for developing a 'pragmatic' mutually beneficial co-operation with Russia and speaking out against a policy of isolation and sanctions will thus become stronger. The declared possibility of a new gas pipeline running to Turkey being built is at the moment a tentative gesture towards Ankara, which has kept a favourable stance on Russian policy over the past few months. However, this is a sign that Russia is ready to go back to the project in a similar or a different form (a pipeline running to both Turkey and its border with Greece). If Russia carries out its plans with regard to Turkey (the construction of a gas hub), it will in fact take control of gas supplies from Turkey to the EU, and thus any future supplies from the Middle East to the EU could potentially be cut off. It cannot be ruled out that Moscow will also use its declaration on its withdrawal from building South Stream to strengthen its narrative concerning its turn to the East as regards gas supplies.

The reasons for halting the South Stream project

This decision is a consequence both of the deteriorating financial situation of Russian energy firms and due to legal problems with the project piling up.

The plan to build South Stream announced in 2006 was one of Gazprom's most expensive infrastructural projects. It was estimated in December 2012 that the cost of the construction of the pipeline would reach around 16 billion euros, but it was announced in October this year that the cost would be more than 40% higher: the cost of the construction of the offshore section rose from 10 to 14 billion euros, and of the land section in the EU from 6 to 9.5 billion euros. Furthermore, a new gas pipeline running through the Russian Federation would have to be built. According to initial estimates, this would have cost 11.3 billion euros, while according to current estimates, it would have risen to 16.4 billion euros. The new estimates are a consequence of the dwindling availability of capital resulting from the sanctions imposed on Russia (the firms which were to be engaged in the pipeline construction, including Stroytransgaz controlled by Gennady Timchenko, and potential creditors, such as Gazprombank, are now on the sanction lists). Furthermore, Gazprom is not planning to increase its investment budget in the coming years. Moreover, the company's draft budget for 2015 even provides for an 18% cut in investment expenses. Meanwhile, Gazprom has to cope with the high cost of implementation of the Eastern gas projects (including the Power of Siberia, which will consume between US\$55 and 70 billion, and Vladivostok-LNG – around US\$13.5 billion). So far, Gazprom has spent around US\$4.7 billion on the South Stream project. The greater part of this sum was allocated to the development of transport infrastructure in Russia, the purchase of pipes to be used in the seabed section, a survey of the Black Sea bed and preparatory work in some of the countries through which the pipeline was planned to run.

Over the past two years, the South Stream project had to face serious legal problems in its contacts with EU institutions. In December 2013, the European Commission officially deemed that some of the intergovernmental agreements which Russia had signed with the countries through which the pipeline was to run did not comply with EU law. Brussels pointed out that the agreements concluded in 2008–2010 failed to take into account the fact that Gazprom as a producer and supplier could not own and operate the gas pipeline; that they did not guarantee third-party access to the pipeline; and that the transit fee issues were treated arbitrarily, disregarding the regulatory authorities. Regardless of its efforts, Russia did not manage to strike a political deal under which the project would be totally excluded from the EU rules set under the “Third Energy Package” (Moscow submitted proposals regarding this issue back in 2012). The criticism from the European Commission affected the stance taken by Bulgaria, which suspended work on its section of South Stream in June this year. Sofia gave assurances that it was still interested in the project, indicating however that it had to be implemented in full compliance with EU law.

The implications of the Russian decision

On the one hand, the announced discontinuation of South Stream's construction is a failure of the Russian energy policy, and in particular of President Vladimir Putin, who had been

personally engaged in pushing through this project at the EU forum. This decision is contrary to the strategic goal of Russian gas policy, namely the diversification of gas export routes to Europe in tandem with the marginalisation of Ukraine as a transit country. The decision to discontinue the construction of the South Stream gas pipeline will certainly give rise to dissatisfaction in the countries which had backed the project (especially Hungary, Austria and Serbia), since they had viewed South Stream as a project of strategic economic significance, offering opportunities to receive tangible economic benefits from Russia. Therefore, Russia hopes that placing the responsibility for the decision to freeze the project on the European Commission and Bulgaria will aggravate the divides which already exist, regarding both energy co-operation between European countries and concerning the policy of sanctions imposed on Russia. The failure of South Stream might be used as an argument for normalising relations with Moscow for the sake of mutually beneficial economic projects. On the other hand, Russia's arbitrary withdrawal from the investment may cause disillusionment with its policy in the region.

In the medium term, Russia's decision is beneficial to Ukraine and Slovakia because it means that the Ukrainian and Slovak gas pipelines will for the time being remain strategically important for the transit of Russian gas to European recipients (around 85 billion m³ of Russian gas was transported via the Ukrainian gas main in 2013, which accounted for 52% of total Russian gas exports to Europe). The recent declaration of its readiness to build a new gas pipeline to Turkey proves that Russia still wants to carry out new gas infrastructure projects in Europe intended at reducing the significance of the Ukrainian transit route. However, it will take some time before they can be launched.

The memorandum signed by Gazprom and Botas initially envisages the construction of a new gas main with a planned capacity of 63 billion m³, the same as had been planned for South Stream. According to statements, only 14 billion m³ would go to the Turkish market, and the rest (almost 50 billion m³) would be supplied to the Turkish-Greek border. Therefore, it cannot be ruled out that Russia's proposal to create a kind of a gas hub there is in fact an attempt at modifying the South Stream project (and resuming the original Blue Stream II) and at putting off the costly investment – something Russia has been forced to do but is potentially more beneficial for it. If Russia supplies gas to a terminal on the Turkish-Greek border, financing the construction of onshore pipeline infrastructure will now become the responsibility of those EU member states which are interested in the project. It is also possible that Russia will decide to reverse the direction of gas supplies via the pipeline running through Romania and Bulgaria to Greece. In this case, gas could be supplied to these countries via Turkey, bypassing Ukraine. A possible implementation of the modified project would also eliminate the legal problems seen during the implementation of the South Stream project.

If Russia builds a gas hub on the Turkish-Greek border, this will in fact mean it would be joining in the implementation of the EU's Southern Corridor concept, which would render the TANAP project pointless (the Azerbaijani-Turkish project of building a gas pipeline running from Azerbaijan via Turkey to the EU; it is scheduled for construction in 2015). The creation of a new gas hub would offer Russia an instrument that would enable it take control over gas transport via Turkey; and this could potentially be used to block other projects aimed at diversifying gas supplies to the EU (plans to import gas from the Middle East, especially Iran).

While the future outline of this investment is still hazy, its political context is very clear. By giving up the South Stream gas pipeline and resuming talks concerning a new gas transport route, the Russian government has ostentatiously strengthened its relations with Turkey, which has recently demonstrated a more favourable stance on the Kremlin's moves than EU member states.

It is also likely that the declaration to withdraw from South Stream will be used by Moscow as an instrument to strengthen its narrative on its strategic turn to the East. The gas deals struck in 2014 (the Shanghai contract envisaging gas supplies from Eastern Siberian fields to China, the so-called "eastern route"; and the memorandum on gas supplies to China from Western Siberian fields, the so-called "western route" or "Altai project") have been presented as an alternative destination for Russian gas exports.