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Nord Stream 2: A Boon or a Threat to European Energy Security?

By David Koranyi

Introduction

There has been much controversy around Nord Stream 2, a planned extension of the undersea gas pipeline stretching from Russia to Germany. By laying down two extra pipes in addition to the two already in operation since 2011-2012, the second phase would see the doubling of the capacity of the route, from 55 to 110 billion cubic meters (bcm) and commence operations in 2019 at a cost of 9.5 billion euros. This would mean that over 70% of Russian gas exports could be channeled through a single pipeline through Germany. Nord Stream 2, coupled with constructing the first two lines of Turkish Stream (with a capacity of 31.5 bcm) would also allow for the complete circumvention of the Ukrainian transit route.

Pros and Cons

There are conflicting arguments over whether the pipeline extension is a benefit or a threat to European energy security. Supporters of the pipeline point towards the multiple crises between Russia and Ukraine in the past two decades and argue that the Ukrainian transit route will remain highly volatile and unreliable in the near- and medium-term due to the ongoing conflict in Ukraine's East. They profess that transit is the real issue and Russia has always been a reliable supplier to Germany and Western Europe even during the years of the Cold War. There are also risks associated with Ukraine's aging pipeline network which would require a major overhaul. Finally they argue that Europe will need more imported gas as its indigenous resources are dwindling, and Russian gas is the cheapest and easiest

option, thus increasing throughput capacities should be a strategic goal.

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Opponents of the extension posit that while Russian gas imports to Europe cannot and will not be substituted anytime soon, increasing European reliance on Russia as the major source of gas import is unwise. They point to the fact that despite major progress in completing the internal energy market in Europe, Russia is still in a position to exploit some fragmented or isolated markets inside the European Union. Nord Stream 2 would have the potential to recreate market dominance and allow Gazprom to isolate certain markets and increase transit fees and prices, with special regard to Southeastern and Central European countries.

In addition there are concerns about the practicality of channeling such large amounts through a single piece of infrastructure. That could be highly problematic in case of a technical malfunction or natural disaster and would also allow the Kremlin to flex its muscles and shut off the tap in case of further deterioration of its relations with the West. The past few years have witnessed peaking tensions and Russian military buildup in the past few years in the Baltic Sea area, this also adds to fears about potential physical risks to the pipeline.

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Opponents of Nord Stream 2 also argue that the best way to ensure Ukraine can raise sufficient investments to modernize its pipeline system is to make sure the system is actively used and generates revenue. In 2017, the Ukrainian gas transport system carried half of Russian gas exports to Europe. Neither Gazprom nor its European clients have ever claimed any technical disruptions. In fact, the Ukrainian system flexibly balances demand fluctuations in Europe and provides backup capacity for periods when other routes, including Nord Stream, stop for maintenance. The only halt of transit across Ukraine occurred in 2009, when Russia stopped gas flows over contractual disagreements, not because of technical issues. What needs to take place is a structured dialogue about modernizing Ukraine's energy infrastructure and incorporating it into the European grid, making use of its great storage potential to offset seasonal demand shifts.

American opposition

In the United States bipartisan opposition of the pipeline is mainly geopolitical. Most in Washington believe that allowing Nord Stream 2 to proceed would reward a Russia

that is belligerent and threatens the established world order. Allowing Nord Stream 2 to be built would send a terrible signal to the Kremlin and the world about the consequences of blatantly ignoring international law and norms. The annexation of Crimea and Russian actions in the Donbass in eastern Ukraine should not be rewarded with business as usual. There is a consensus in Washington, that the West must continue to put pressure on Ukraine to deliver on its economic reform agenda, but undermining basic solidarity with a country under siege would erode the credibility of the transatlantic alliance as a whole.

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Furthermore, as the US becomes a major gas exporter, US companies are eyeing the European market (though they are much more interested in Asia where most demand growth will occur and prices will likely be higher). Though the role of gas in EU “energy diplomacy” has been emphasized ad nauseam, gas export decisions are ultimately made on commercial terms. Russian gas enjoys a significant advantage over LNG when it comes to cost levels.

Yet as the example of the Lithuanian floating LNG terminal shows, access to LNG can be an effective bargaining chip in negotiations with Gazprom and a safety valve in case of another

protracted supply security crisis. With EU support, there is a window of opportunity to put in place new LNG facilities in southeastern Europe, including in Croatia that may not be viable on purely commercial terms but would serve a critical supply security role for the entire region.

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Increasingly flexible and lower-cost infrastructure, such as floating regasification and storage units and potentially small-scale LNG solutions would be highly advantageous for Croatia and would enhance the country’s geopolitical as well as its economic importance as the gateway for (American and other) LNG supplies into Central and Eastern Europe.

Shifting sands

Until recently and despite the vehement opposition both within the European Union and in the United States, the development of Nord Stream 2 seemed to be on track. Despite strong objections by member states in Central and Eastern Europe (primarily Poland, the Baltic States, and to a lesser extent the other Visegrad Four states) as well as Ukraine, Germany seemed determined to push ahead.

Yet we have seen more cautious statements out of Berlin lately. Chancellor Angela Merkel said in early April 2018 that "in our view, the Nord Stream 2 project is not possible without clarity of how Ukraine's transit role will continue. From this you can already see that this is not just an economic project, but that, of course, political factors must also be taken into account."

Angela Merkel said in early April 2018 that "in our view, the Nord Stream 2 project is not possible without clarity of how Ukraine's transit role will continue."

The importance of her statement is hard to overestimate. It was the first time she acknowledged the political nature of Nord Stream 2. Her hardened stance may be connected to the nerve agent attack on UK soil and ensuing further deterioration in EU-Russia relations as well as a tougher line on Russia by her new foreign minister Heiko Maas signaling a shift in coalition partner SPD's traditionally Russia friendly attitudes, even if key German business actors remain highly supportive of the project.

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Another factor to consider is the sanctions legislation adopted by US Congress last August that opens the door for potential sanctions against Nord Stream 2 and its backers. This option can be triggered by the US President and "in consultation with allies". At the time of writing there is no indication President Trump is considering the use of this clause. The US State Department also issued guidance that sanctions apply only to energy pipeline projects initiated on or after August 2, 2017 which would exempt Nord Stream 2. Yet if relations between the West and Russia deteriorate further, imposing sanctions on companies participating in the pipeline may be put back on the table, delivering a severe blow to the project, potentially rendering it moot. Permitting may be another obstacle as the project still awaits for environmental permits from Sweden and Denmark (all necessary permits have already been granted by Germany and Finland).

Conclusions

There are three possible outcomes. The commercial interests in Germany may trump the geopolitical considerations and Nord Stream 2 will eventually be pushed through by the end of 2019 as planned despite all the objections. If EU-Russia relations continue on a downward trajectory and/or US sanctions are triggered, Nord Stream 2 could be postponed or shelved indefinitely. One could imagine a compromise solution whereby Nord Stream 2 gets built but not all of its capacity used, guaranteeing the continuation of the

Ukrainian transit route albeit in a diminished capacity.

Construction is supposed to commence in the second half of this year. All eyes will be on Berlin and Washington in the meantime.

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