CENTER FOR THE STUDY OF DEMOCRACY

TURKSTREAM AND THE RUSSIAN ECONOMIC INFLUENCE IN EUROPE

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Russian economic influence in Europe is centered on energy. The Kremlin has sought to undermine or avoid common EU energy rules, manipulate and monopolize energy markets. It has sought to exploit governance loopholes and lock in governments and local oligarchic networks in corrupt large-scale energy projects. The pinnacle of this strategy has been Russia's two politically driven gas projects – Nord Stream II and TurkStream. By sowing discord among affected European governments Russia undermines Europe's energy security[1].

The key proponents/beneficiaries of both projects are business and patronage networks close to the Kremlin. This is paraded openly in the case of Nord Stream II. But it has also been the case in the much stealthier but arguably more strategically harmful TurkStream. Over the last decade, the project has successfully gripped the energy policy attention of Southeast European governments, binding them in asymmetric relations with the Kremlin. Completing the TurkStream pipeline will have a range of negative impacts on European energy security:

- preserving the dependence on Russian gas amid enormous and unnecessary

KEY POINTS

- Russia has sought to undermine common EU energy rules and monopolize markets by promoting two politically driven gas projects: Nord Stream II and TurkStream.
- The EU push for gas diversification fell prey to the private interests of European energy companies, financial institutions, construction firms and industrial behemoths that have benefited from Gazprom-led projects.
- TurkStream will perpetuate SEE dependence on Russian gas amid enormous and unnecessary infrastructure spending diverting scarce resources away from productive investments.
- The project blocks the diversification of gas markets, including by preventing cheaper LNG supply to compete with Russian gas in Europe.
- The EU should develop a robust monitoring and enforcement mechanism to be able to discontinue energy projects that might undermine the security of supply, energy source diversification and the integration of the EU energy markets in its different regions.
- The EU and the U.S. should assist national governments and gas companies to renegotiate their long-term contracts with Gazprom with the aim of abolishing destination and take-or-pay clauses, reducing their overall duration to a maximum of 2 years and replacing oil-price indexation to spot-based price-setting linked to a liquid European gas hub.

[1] Shentov, Ognian, Stefanov, Ruslan and Vladimirov, Martin. Kremlin Playbook in Europe. Sofia, Center for the Study of Democracy, 2020.

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infrastructure spending diverting scarce resources away fromproductive investments;

- amplifying Russian malign influence through feeding corrupt pro-Kremlin oligarchic networks and reinforcing state capture in the countries along the route of the pipeline;
- blocking of the liberalization and diversification of gas markets, including by preventing cheaper LNG supply to compete with Russian gas in Europe.

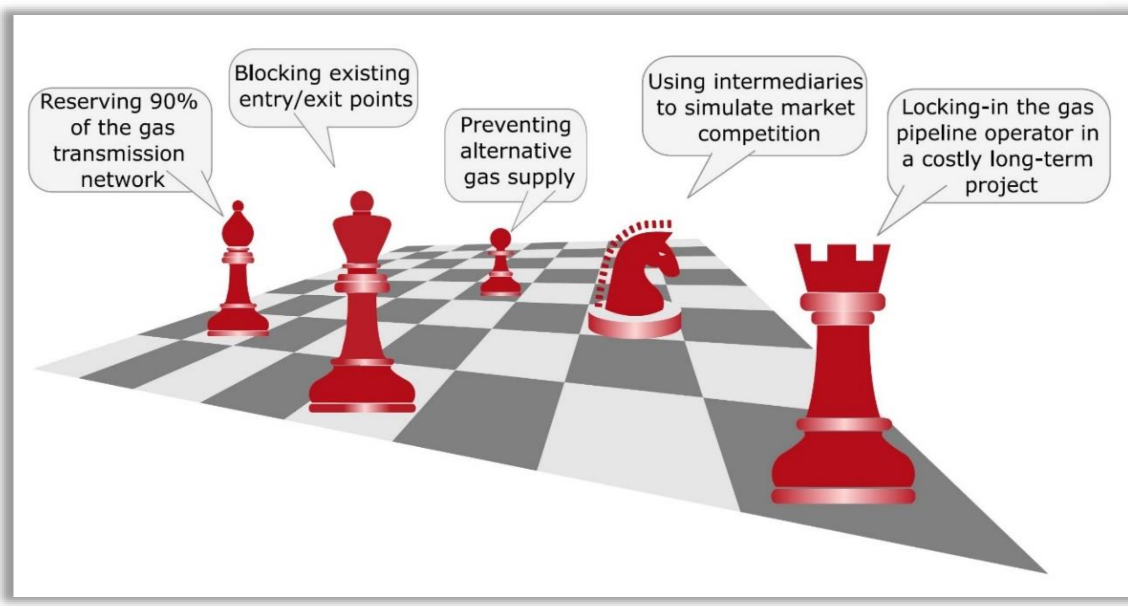
Fueling Europe's energy insecurity

The Russian foreign policy campaign of circumventing Ukraine and expanding Europe's dependence on Gazprom has proven successful. The share of Russian gas in the European gas market steadily rose to 34% in 2019, up from below 30% a decade ago. While alternative supply routes have become more readily available, most of Central and Eastern Europe countries remain excessively dependent on a single supplier: Gazprom.

The Russian company has been able to retain clients through tactically lowering prices for some countries with higher bargaining power, in spite of price convergence on the global market. It has grudgingly provided more flexible terms and concessions following an EU anti-monopoly probe. Yet, Gazprom has consolidated market share in Europe amid strong competition from LNG and stagnating gas demand caused by improvements in energy efficiency and the advance of renewables.[2] As part of promoting both Nord Stream and TurkStream, Gazprom has locked its main clients in Western and Central Europe into new contracts, preempting their search for alternative suppliers once existing long-term agreements expire in the early 2020s.

The strong support of Germany and other European governments for the implementation of Nord Stream's second string has in practice made TurkStream inevitable and any coordinated EU response towards the project unlikely.

Figure 1. The Gazprom Market Dominance Strategy in Bulgaria



Source: CSD

[2] Ibid.

While they might not be commercially viable (the total investment by Gazprom to implement the projects is estimated at $115 billion[3,4]), the two pipelines could be seen instead as a strategic investment in expanding Russia's political influence in Europe.

Nord Stream II has created a precedent, in which a politically-driven pipeline that does not contribute to the diversification of the European energy supply receives a de-facto exemption from the EU energy competition rules. The EU push for diversification away from excessive Russian gas dependence that started in 2009 fell prey to the private interests of well-connected large European energy companies, financial institutions, construction firms and industrial behemoths that have benefited from the construction of Gazprom-led pipelines. Paradoxically, the U.S. has remained the most consistent adherent to a common European energy security policy. In December 2020, the U.S. Congress extended the scope of sanctions against companies participating in Nord Stream II and TurkStream through the 2021 National Defense Authorization Act (NDAA), which is likely to delay or even block the final steps in the implementation of the two projects.[5] EU governments hosting the pipelines have protested or chose to ignore the sanctions and Germany has continued the construction of Nord Stream a week after the publication of the draft bill[6].

From its onset, the TurkStream pipeline has been designed to serve the Russian energy interests and to further entrench existing state capture networks by providing well-connected companies with business opportunities at premium returns.[7] TurkStream was planned to continue to Europe from Turkey either via Bulgaria or Greece to reach Serbia, Hungary and Austria. Gazprom announced that the European stretch of the new pipeline network will be implemented by the host governments entirely (with the exception of Serbia where Russia owns 51% of the project construction company).

Russia has now locked national gas companies in CEE into 20-year shipping contracts with Gazprom, which would strain their financial position and limit their gas options. TurkStream would also crowd out alternative gas projects as most of the domestic gas pipeline capacity would be booked by one supplier. Under continuous pressure from Russia, governments rushed through all the needed procedures to start construction in 2019.

Tellingly, Bulgaria, for example, laid down the first pipes of TurkStream before the country finally commenced construction of the strategically important yet decade in the making interconnector with Greece (IGB). Unlike in 2014 when the construction of South Stream was about to start, with TurkStream the European Commission did not intervene or express any opinion about the legality of the project. The way the project has been structured, namely as an expansion of the existing domestic gas network without Gazprom ownership (in the Bulgarian case) and with guarantees for

[3] Krutihin, Michail. Непокоренная Европа: какую цену придется заплатить России за «Северный поток-2. *Forbes*, 4 November, 2019.

[4] Cost information for Nord Stream II and TurkStream can be found on the projects' websites.

[5] United States Congress. S.4049 - National Defense Authorization Act for Fiscal Year 2021. 4 December, 2020.

[6] DW. Russia resumes Nord Stream 2 construction despite US sanctions. 11 December, 2020.

[7] Stefanov, Ruslan and Vladimirov, Martin. The Kremlin Playbook in Southeast Europe: Economic Influence and Sharp Power. Sofia, Center for the Study of Democracy, 2020.

nominal access to the grid by alternative companies, allowed the Bulgarian government to avoid EU scrutiny.

Governance Effects

The implementation of the TurkStream project has revealed a number of structural deficiencies in the governance of the energy sector in CEE, such as the lack of a detailed cost-benefit assessment of the project, transparency, or consistency with long-term energy policy and security objectives. Many details of the project's implementation, including the terms of compensation and cancellation of the contract in case Gazprom does not ship any gas are currently unspecified. The concerns about the management of the project were further substantiated by the lack of transparency in the public procurement procedures for the choice of an engineering, procurement and construction (EPC) contractor.

The tenders for capacity bookings on the new pipeline and for the choice of contractor have been pre-designed in such a way as to formally comply with EU rules without guaranteeing real competition by bidders. EU rules on energy market competition have been circumvented by providing nominal third-party access to the pipeline and a separation between the gas supply and gas transmission ownership.

Russia has been using Saudi, Belarussian and European companies to evade the U.S. sanctions against the project[8]. Russia ships the gas, builds the pipeline and finances it through proxy entities that obfuscate the real origin of the financial flows. Russian citizens and former Gazprom officials have taken over the management of the consortia building the TurkStream pipeline and have used proxy Russian firms to complete the construction and to facilitate the financing of the project via offshore entities. Lax oversight in the regulatory framework of a number of Western European countries regarding company law, taxation and incorporation has allowed Russia to hide the true origin of the funding for the project by using a complex financial scheme and an obfuscated corporate structure[9].

Despite the lack of an independent cost/benefit analysis, governments in the region have committed financially to the project. The Bulgarian section of TurkStream would cost around EUR 1.5 billion for the construction but will also require another EUR 750 million in maintenance making the project loss-making for the first 15 years of its operations [10] . Meanwhile, by committing to transiting Russian gas coming from Turkey, the Bulgarian government was forced to replace its ship-or-pay transit agreement with Gazprom with guaranteed revenues of more than EUR 700 million until 2030 in exchange for the new TurkStream transmission contract. Hence, the actual profit from the new pipeline infrastructure could be lower than the one from the existing agreement where the national transmission operator had only small operational costs in maintaining the pipeline.

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[8] Stanchev, Ivaylo. Как Русия си взе газопровода и 3 млрд. лева [How Russia took its gas pipeline and BGN 3 billion]. *Capital*, October 16, 2020.

[9] The documents also reveal that Russia has also been financing the construction of the pipeline via a TMK-controlled Luxembourg-registered offshore company, Completions Development S.A.R.L., which has paid for the pipes' delivery and for a significant share of the construction. In addition, Russia-controlled (VTB and International Bank for Economic Cooperation) and Russia-dependent banks (ING and Raiffeisenbank) including their subsidiaries operating in Eurozone countries such as VTB Europe have provided loan support for the implementation of project.

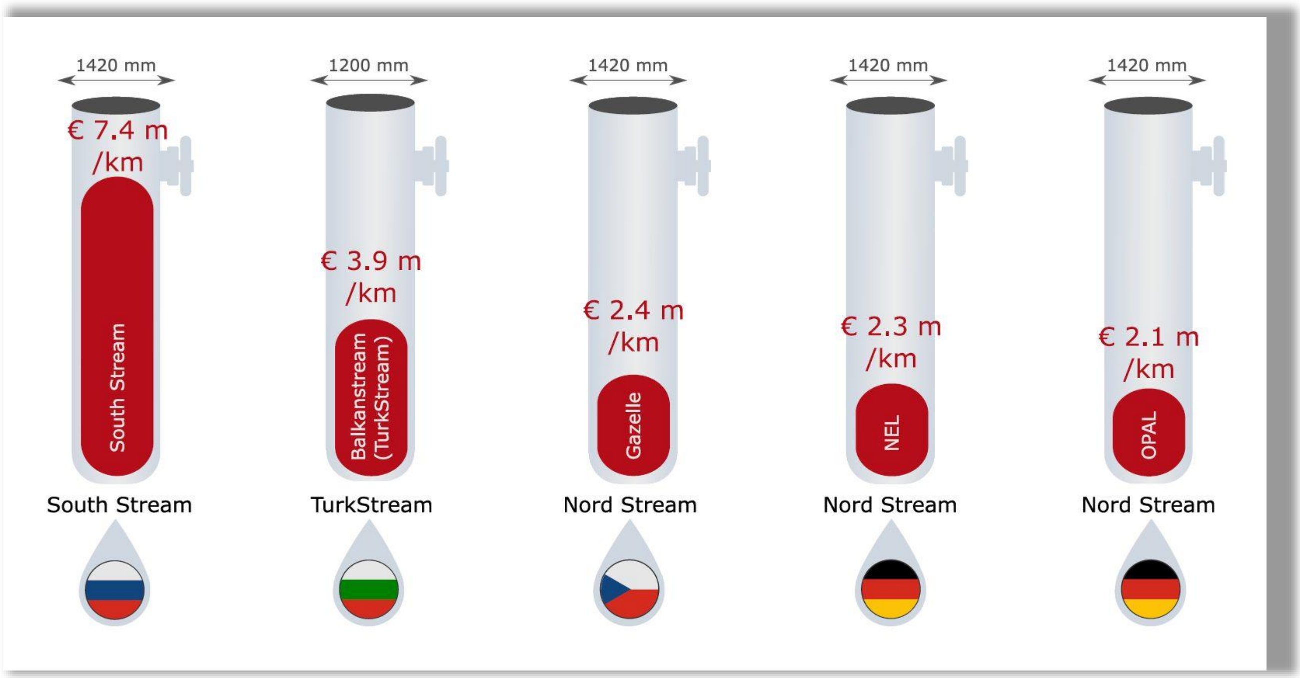
[10] CSD estimates based on the projected construction and exploitation costs, and the transit revenues based on the capacity booked by Gazprom on the Turkish and Serbian borders.

The completion of the Serbian section of the pipeline would have an even stronger impact on the domestic gas market and the financial situation of the Serbian national gas company. The Serbian section of the project, costing around $1.4 billion, would be implemented by a consortium made up of Gazprom with 51% and the state-owned Srbijagas company (49%). Thus the Serbian state would be directly involved in the financing of the pipeline while allowing Gazprom to take control of the main part of the domestic pipeline network of the country.

TurkStream will also effectively redirect Russian gas imports coming from Hungary, and thus, prevent the potential access of Serbian consumers to alternative supply sources.

Although the pipeline routes for TurkStream and South Stream are almost the same, the lower capacity of the former project partially explains the reduced cost structure. However, the construction costs exceed the average costs for the implementation of even bigger-diameter-pipeline projects across Europe. As with most Gazprom-led projects, this could be related to a corruption premium, which would be allocated to a group of well-connected private interests.[11]

Figure 2. The Corruption Premium in Gazprom Projects? Comparative Pipeline Costs for Similar Projects in Europe



Source: CSD

[11] Center for the Study of Democracy. Bulgaria and the South Stream Pipeline Project: At the Crossroad of Energy Security and State Capture Risks. Sofia, 2015.

What's Next?

Benefits from the project in the short run seem to accrue to the Russian side, while the expected return to the countries in CEE in the long-run is dependent on more and more risks and uncertain conditions. The project does not address any of the severe immediate energy security risks faced by the region: energy poverty, energy intensity, and rising indebtedness.

The EU needs to work with the US to design a more coherent response to limit Kremlin's negative influence on CEE energy security:

- The EU should develop a robust monitoring and enforcement mechanism to be able to discontinue energy projects that might undermine the security of supply, energy source diversification and the integration of the European energy market.
- The U.S. government should support the development of more viable gas market alternatives including encouraging Azeri authorities and stakeholders in the Shah Deniz consortium to offer more flexible supply conditions for the countries along the Southern Gas Corridor.
- The Three Seas Initiative should become an effective mechanism to attract more LNG imports in Europe and incentivize European countries to join the development of the EastMed gas fields to ensure further diversification and business options away from Russia.
- The EU should increase its support for the expansion of regional natural gas interconnectors, storage facilities, and regasification terminals in CEE in order to increase the liquidity and competitiveness of the market.
- The EU and the U.S. should assist national governments and gas companies in seeking a renegotiation of the long-term natural gas contracts with Gazprom with the aim of abolishing destination and take-or-pay clauses, reducing their overall duration to a maximum of 2 years and replacing oil-price indexation to spot-based price-setting linked to a liquid European gas hub.