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Power struggles: Europe and Russia’s rising tensions

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The crisis in Ukraine has dominated headlines in recent weeks, and the European energy sector in particular is growing increasingly vulnerable to the rising political tensions. The annexation of Crimea by one of the world’s most potent energy producers has already started to affect the energy market. Russian state energy giant Gazprom has hiked up its energy prices by more than 80 per cent to the Ukraine in the past week, and the South Stream Russia-Europe pipeline project has been thrown into doubt as Brussels has stopped talks with Russia over the deal. Already mired in confusion regarding the timelines and legality of the project, the €17 billion (US$23.4bn) pipeline deal is now in a state of limbo, sponsor Eni said in March.

Breaking away

What will happen to energy projects in Ukraine? The impact on future energy projects in Ukraine may be seen in an increased cost of capital and a higher risk profile. But IJGlobal data suggests that there are not many in-development projects in the country in the first place: merely three medium-sized wind projects (Zaporizhia, Stavki and Beregovaya). What may be more critical to Ukraine's energy market is the impact of the crisis on the supply and distribution of its power. Nuclear and imported Russian gas feature large in the country's energy mix, and Ukraine is dependent on Russia for most of the uranium that supplies its 15 nuclear reactors. A significant US$238 million power tranmission project, supported with a US$200 million debt commitment from the IBRD, is ongoing, and the escalating tensions may make completion of the project even more desirable: as it stands, over two thirds of the country's transmission lines have exceeded their lifespan.

The distancing from Russia may serve as a driver for faster development of new energy projects across Europe, not just in Ukraine. As Crimea breaks away from Europe, Europe in turn is aiming to loosen its ties to Russia. European chiefs are mindful of the fact that the Ukraine is a key gas transit company. Around 50 per cent of gas that reaches Europe from Russia is transported via Ukraine, and if tensions escalate, gas supplies can be cut off by Russia. The European Union is serious about reducing its dependency on Russian energy infrastructure and power, and there is a pipeline of European oil and gas projects that it hopes will help to bolster energy independence. Rival pipeline projects to South Stream are also in development; the Shah Deniz consortium’s Shah Deniz Stage 2 project combines two pipelines designed to divert from traditional Russian supplies. The Trans-Anatolian Pipeline (TANAP) will transport gas across Turkey and the Trans-Adriatic Pipeline (TAP) will transport gas from the Turkish-Greek border to Italy.

Seeing as Europe is still reliant upon Russia for around a third of its oil and gas supplies, increasing local production may soon be viewed as an increasing priority. Croatia this week launched a tender for oil and gas exploration in its Adriatic waters. Concessions are expected to be awarded to oil and gas majors by early 2015 at the latest, and Britain launched a new round of offshore oil and gas licences in January. An onshore UK licencing round, which is expected to include shale gas drilling licences, is expected in the summer.

Beyond pipelines, oil refinery projects such as Turkey's STAR Rafinery will also strengthen Europe's petrochemical production capacity. There has been much talk of shale gas production over the past year too, but it remains to be seen whether shale will experience the success it has enjoyed over on the other side of the Atlantic.

The crisis and prices

Of course, the full impact of the current crisis can only be judged retrospectively, but in these early stages, delays to project construction (as seen with South Stream) and alarming energy price rises are already taking place. However, professor of global energy at Warwick Business School Michael Bradshaw said that price hike should not come as a shock to Europe. "It really comes as no surprise that Gazprom has put its prices back up. The real problem is Ukraine's inability to pay its gas bill; this was behind previous gas crises in 2006 and 2009. The West will need to provide the Ukrainian government with financial support to pay its debt and finance future purchases to avoid providing Russia with the pretext for cutting off the gas."

Bradshaw pointed out that Ukraine's wholsesale energy prices were discounted beforehand. "The initial discount to Ukraine from Gazprom was part of a wider package of economic incentives, including a substantial loan." These earlier, cheaper gas prices also had a political basis, Bradshaw said. "They were a reward last November to the former President of Ukraine Viktor Yanukovych for rejecting a closer relationship with the EU in favour of Russia's Eurasian economic union. The new interim government in Ukraine is now building closer links with the EU and the west more generally, hence the discount is no longer on offer." Beyond the current crisis, there seems little doubt that Ukraine's difficult, complex relationship between political power and its energy supplies is firmly entrenched.