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**Research Report**

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# Eurasian Economic Union Integrates Energy Markets – EU Stands Aside

*Maria Pastukhova and Kirsten Westphal*

The process of establishing a common energy market in the Eurasian Economic Union (EAEU) is moving forward after Russia and Belarus succeeded in resolving important differences. This reorganisation of the energy space will also affect the European Union, because Russia and Kazakhstan are major oil and gas suppliers, and important export pipelines originate there. At the same time regulatory and technical fault lines are becoming apparent between the EU/European Energy Community and the EAEU – also affecting transnational physical infrastructure. Furthermore, the integration blocs overlap in sensitive regions like the Caucasus, the Black Sea region and the Baltic states.

The EU remains sceptical towards the Eurasian Economic Union (EAEU), which was founded in early 2015 by Russia, Armenia, Belarus, Kazakhstan and Kyrgyzstan. The EAEU has ambitious energy policy goals: a common electricity market by 2019, a common oil market by 2024 and a gas market by 2025.

The EAEU's integration process is driven by more than just Russia's geostrategic interest in consolidating its own sphere of influence. It also offers its members a survival strategy for economic systems still heavily shaped by their Soviet heritage and value chains. One concrete indication that the EAEU is more than just a Moscow-driven project is the consensus principle for decisions in the EAEU's highest supranational organ, the Supreme Eurasian Economic Council, and in its most important over-

sight body, the Council of the Eurasian Economic Commission. Decisions in the Board of the Eurasian Economic Commission, are by consensus or two-thirds majority, with each member state supplying two representatives regardless of size and economic strength.

## Energy Market: Progress since 2015

Under the Treaty establishing the EAEU in 2015, cooperation and integration in the field of energy is one of its main objectives. Energy market concepts for the three principal energy sectors– electricity, oil and gas – were drafted by the Board in 2015 (see [SWP Comment 9/2016](#)) and adopted by the Supreme Economic Council in spring 2016. Based on these concepts, individual programmes for electricity, oil and gas will

define timeframes and lay out fundamental principles for cooperation. Ultimately the programmes will serve as the basis for the national development plans of the individual EAEU member states. In recent months the EAEU has made progress on formulating the programmes, even if implementation will require time for coordinating and implementing standards, norms and processes.

The Council of the Eurasian Economic Commission adopted the programme for the development of a common electricity market on 30 November 2016. It was able to move fastest on electricity, where the discussions are less politically sensitive and existing trading platforms can be used to create a common market. Although a concrete pricing mechanism has yet to be finalised, it is already clear that the proposed energy exchanges will function under common rules. Since the EAEU was established, cross-border electricity trading has grown by 24 percent to 7.61 terawatt hours per annum. Overcapacity – with total installed capacity in the member states exceeding 282.8 gigawatts – and modernisation requirements generate extensive potential for synergies.

The Board of the Eurasian Economic Commission approved the programme for a common oil market on 12 September 2017. It passed the Council on 20 December 2017 but has yet to be signed by the heads of state. The programme will abolish state regulation of oil pricing within the EAEU and create a common market exchange by 2021, as well as guaranteeing non-discriminatory access to transport pipelines.

The common oil market will be coordinated with the EAEU's transport and infrastructure policy. Implications for infrastructure projects must be anticipated not only within the EAEU member states, but also for transport links to third countries. Tariffs for transport of crude oil between EAEU states, for transit of crude and for resale of crude and petroleum products to third countries are to be harmonised, and infrastructure projects will be coordinated

at EAEU level. This arrangement will on the one hand grant the oil-producing members (Kazakhstan and above all Russia) greater leverage over Belarus, as Minsk will be losing its ability to make unilateral decisions on tariffs and transport for its (re-)exports of crude and petroleum products. On the other hand, the EAEU's position in Eurasia will be strengthened, because new oil-related infrastructure projects "of mutual interest" will no longer be realised unilaterally or bilaterally but agreed and implemented multilaterally at the level of the Economic Union. This could for example force China to develop the Eurasian infrastructure elements of its Belt and Road initiative in cooperation with the EAEU, rather than bilaterally with individual countries as it has to date. Especially for the Central Asian countries, the EAEU clearly represents an important component of a multivectoralism designed to avoid becoming subsumed entirely into China's sphere of influence.

The EAEU is also discussing harmonisation of energy statistics, a shared data-gathering system and common quality standards. Committees are already working to list measures required to regulate integrated oil and gas markets, such as inclusive auction processes, access to transport systems, and trade mechanisms for oil and gas. Even if these programmes are tailored to the internal markets, the emergence of EAEU-wide energy markets could also impact external relations. However, all the programmes are as yet very vague, and still need to be translated into technical norms, regulatory standards and legal provisions.

### **Integrated Gas Market: Biggest Hurdle Already Cleared**

The concept for the EAEU gas market was approved in spring 2016 at the same time as the oil concept. But the negotiations over this integrated market were subsequently stalemated for a considerable period, above all on account of Russian-Belarusian energy dispute (see [SWP Comment 15/2017](#)).

In early 2016, at a point where gas prices were falling in the EU, Minsk declared that it was paying too much for Russian gas. In 2016 Belarus unilaterally cut the price it paid Gazprom from the agreed \$132 per thousand cubic metres to just \$73, and as a result accrued debts to Gazprom exceeding \$720 million. Russia responded by cutting oil exports to Belarus, dealing a grave blow to the latter's oil-dependent economy.

In April 2017 Presidents Vladimir Putin and Alexander Lukashenka reached a compromise under which Belarus will receive Russian gas for three years at prices lower than that of 2016 (\$130 per thousand cubic metres for 2017, \$129 for 2018 and \$127 for 2019). The price formula will remain based on the price of gas in the Yamalo-Nenets Autonomous Okrug in northern Russia. On 13 April 2017 Belarus paid Gazprom \$726.2 million owed for Russian gas supplies in 2016/2017. The use of gas pipelines and other infrastructure will in future be governed by EAEU rules for access to the services of natural monopolies and Russia will increase its duty-free oil exports to Belarus from 18 million to 24 million tonnes annually until 2024. While 18 million tonnes ensure that Belarusian oil refineries can operate at full capacity, the other 6 million can be exported directly with the export duties accruing to the Belarusian state budget. One important condition attached to the agreement is that the two sides agree a "sustainable programme for a common gas market in the EAEU" by the end of 2018.

This agreement demonstrates Russia's enormous influence on its neighbour's energy policy, on account of the Belarusian economy's dependency on refining and processing Russian oil and on supplies of Russian natural gas. But the agreement also removes the most important obstacle on the road to a common energy market. The April 2017 accord ensures, firstly, that – as long as the pricing mechanisms of a common EAEU gas market cannot be applied (probably until 2024) – gas prices for Belarus can be calculated using a formula that is more or less acceptable to both sides. As

such, Belarus has postponed its wish for a netback pricing formula until the creation of a common gas market. Secondly, the EAEU standards agreed to date (in other words rules for access to the services of natural monopolies) are at least partially applied to the bilateral gas trade.

### **Further Progress in the Gas Market**

The deal between Moscow and Minsk put the integrated gas market back on the agenda. The Eurasian Economic Commission's advisory committee for oil and gas approved the programme for such a market on 24 April 2017, and the Board adopted it on 12 September 2017. Unlike the programme for the integrated oil market, which provides for common tariffs and mechanisms for transit and export to third countries, the programme for the integrated natural gas market applies exclusively to extraction, trading, transport, storage and processing within the EAEU.

Another objective is to ensure non-discriminatory access to transport services of natural monopolies (meaning gas pipelines and related infrastructure) for the participants in the integrated gas market. Alongside harmonisation of norms and standards in the integrated market, control mechanisms are also to be developed to avoid the EAEU's internal tariffs applying to its external trade: these will include preventing resale to third countries of gas purchased for domestic consumption within the EAEU. That will preserve Gazprom's monopoly on pipeline exports.

The regulatory and institutional framework for a liberalised gas market in the EAEU has yet to be developed. The programme proposes a dual pricing mechanism for transnational gas trading in the EAEU. The price of gas traded under bilateral agreements will remain subject to state regulation, while market pricing will be facilitated for the rest (both long-term contracts and exchange trading). There is also a long-term objective of developing a pricing mechanism that ensures identical

margins across the EAEU, but this will probably have to await the agreement of a treaty establishing a common gas market.

The volume of gas traded within the EAEU is comparatively small, with 33.5 billion cubic metres per annum as against 177.4 billion cubic metres exported to third countries. But the volumes traded at the Russian platform Spimex (St Petersburg International Mercantile Exchange) are growing steadily: from 0.5 billion cubic metres in 2014 to an estimated 21 billion cubic metres in 2017. There is good reason to believe that the Russian exchange will slowly establish itself at least as a price marker if not as the central trading place.

Of course, in the first place the programme reflects the interests of Russia as the EAEU's biggest gas exporter. The new control mechanisms would grant Moscow another instrument to prevent, for example, gas supplied to Belarus or Kazakhstan being sold on to Europe or China. On the other hand, the gas-importing member states retain the right to receive cheap supplies from Russia under bilateral agreements, so a balance of interests is obtained.

### **Expanding External Relations**

Both the energy market concepts and the existing agreements suggest that the harmonisation of norms and rules, the standardisation of pricing mechanisms and the codification of standards and data all relate initially only to energy trading *within* the EAEU. But the EAEU is also working on its external relations. In Asia it has encountered interest both among individual states – including India, Mongolia, Singapore and Vietnam – and from international organisations seeking economic cooperation with the EAEU and participation (also financial) in its integration processes.

China naturally plays an outstanding role, and the EAEU heads of state lost no time initiating talks with Beijing in 2015. China is the second-largest trading partner for the EAEU, which regards it as a strategic economic partner in the Asia Pacific region.

Both Beijing and the EAEU members are very interested in bringing the EAEU together with the Chinese Belt and Road initiative. Both sides regard the two projects as complementary. Talks over an agreement on trade and economic cooperation between the EAEU and China began in June 2016. Since October 2017 the Eurasian Economic Commission has been preparing an agreement in cooperation with business representatives.

Cooperation with China is sought not only at the level of trade relations, but also in the development of a common transport and energy space. In March 2017 the Eurasian Economic Commission identified a list of infrastructure projects supporting the Belt and Road initiative to be conducted in the scope of the EAEU. Thirty-nine of them fall within the category of transport (for example modernising existing routes or developing logistics and transport hubs). The proposed web of Eurasian infrastructure also comprises energy projects, including another gas pipeline to China: the Beineu-Bozoi-Shymkent Gas Pipeline, through which the first five billion cubic metres of Kazakh gas flowed in autumn 2016. Funded jointly by KazTransGas (Kazakhstan) and the Trans-Asia Gas Pipeline Company Limited (China), its capacity is to be expanded to 15 billion cubic metres annually. The possibility of using it to transit Russian gas to China has also been discussed. All this shows that Eurasian interconnectivity is being pushed by the EAEU and naturally – in the scope of the Belt and Road initiative – especially also by China.

### **EU Stands Aside**

Beyond the EU, energy spaces are experiencing restructuring. As yet Brussels has made no official contact with the EAEU, despite the latter's great interest in cooperation. Political spokespersons of the EAEU, as well as representatives at working level have consistently expressed the wish for exchange with the EU on "best practices" in the areas of energy and transport. The

EAEU regards dialogue with Brussels as logical and objectively overdue: it views the “European vector” as an external economic priority, and seeks closer cooperation with the EU in particular in the areas of technology, energy efficiency and Industry 4.0. Moreover, dialogue between EU and EAEU is seen as vital for economic cooperation in Europe.

The reasons why the EU remains on the sidelines include scepticism about whether the EAEU project will really materialise. Here Brussels is ignoring both the most recent developments within the EAEU, which is continuing to deepen despite political differences between its members (see [SWP Comment 9/2016](#)), as well as the growing economic confluence between the EAEU and countries in the Asia-Pacific region. One reason for the EU’s reticence will certainly be the EAEU’s strategic importance for Russia and its consequent geopolitical relevance. For Moscow the EAEU is one element of the balance of power in a multipolar world, creating a counterweight to both China’s Belt and Road initiative and to the European Union. But in restricting its vision to geopolitics and security, the EU is ignoring the EAEU’s potential to generate progress on market liberalisation and diversification.

The energy space joining Europe and Asia is increasingly being shaped by actors other than the EU (see [SWP Research Paper 4/2017](#)). China’s Belt and Road strategy, which is successively bringing in individual EU member states through moves like the 16+1 initiative, is the most prominent example. In general terms, it is energy infrastructures and interconnectivity that create and shape integrated energy spaces. If diverging legal and regulatory spaces now emerge, new fault lines, barriers and fractures will appear where they meet, with repercussions for commercial activity and market transactions. Ostensibly technical and commercial processes have potentially major political effects; they can disrupt the operation of infrastructures, deepen divides and exacerbate geopolitical conflicts.

The EU’s activities to date have concentrated on the European Energy Community, which includes the states of the Western Balkans, Moldova, Ukraine and Georgia. The Energy Community seeks to establish a stable regulatory framework and reliable market mechanisms by gradually introducing key elements of the EU’s *acquis communautaire* in the area of energy. Alongside a fundamental overhaul of national laws and regulations, this presupposes deep structural reforms. Turkey and Armenia already possess observer status in the Energy Community; Belarus has applied. While Brussels is working towards a common market encompassing the EU and the Energy Community, at the boundaries divides are deepening. But neither the geopolitical nor the (geo-)economic repercussions of the emergence of increasingly distinct energy blocs can lie in the interests of the EU. A whole series of concrete and fundamental arguments thus mitigate in favour of dialogue with the EAEU.

### **Ten Reasons for Strategic Dialogue**

1) *Avoiding regulatory barriers.* It should be in European’s interest to avoid regulatory barriers within its broader region. Ultimately the region stretching from western Siberia and Central Asia all the way west to Lisbon is interconnected by pan-European energy corridors and transnational oil, gas and electricity networks. In the interests of ensuring security of supply it is crucial for cross-border infrastructure and energy trading to function without a hitch.

2) *Compatibility and the free-market model.* If European businesses are to enjoy market opportunities, it is central that the norms, standards and rules of the EAEU be compatible with the EU mechanisms. Otherwise the EU risks ending up in the role of “rule-taker”. Being forced into adapting to standards “from the east” could prove a costly business.

In view of the crisis of free-market trade and the rise of China’s mercantilist trade model (on which its Belt and Road strategy is based) the EAEU acquires more than an

important bridging function. As an important energy-producing region it also plays a key role in constructing a (globally) liberalised energy market.

3) *Maximising the geographical scope of markets.* The EU's reticence is also surprising in view of the history of European integration and the EU's "integrative DNA". In the 1990s, the EU was working to establish and expand relations with other integration formations. Yet even then, bilateralism predominated towards former members of the Soviet-led Comecon. Today the EU is concentrating on consolidating its own energy market, rather than pursuing the objective of expanding the market space. This underlying pattern is amplified by mistrust towards Russia and its plans. But dismissing the EAEU as Moscow's project would mean yet again viewing the region solely through a geopolitical lens. This risks driving market segmentation and wasting strategic advantages.

New markets are in fact at stake, but also adaptation to the new realities of a multipolar world. The EU can only profit from a multivectoralism that relativises China's influence (and Russia's). Some members of the EU and Energy Community share such an interest in diversifying economic relations with the members of the EAEU – in particular those that experienced bloc allegiances in the past and hoped they had left these behind them.

These abstract reasons would suggest that the EU should follow and support the EAEU's energy market processes at the technical, operational and regulatory levels. Compartmentalisation of energy questions is advisable and expedient because the EU is pushing ahead with its own internal Energy Union, because Brussels already has an instrument at hand in the Energy Community, and because steps have thus already been undertaken to shape the own external relations. With such an approach it will also be possible to find answers to the concrete problems outlined in the following:

4) *Gas transit through Ukraine.* Disputes about operating arrangements for cross-

border export pipelines have repeatedly generated public concern. With regard to Russian-Ukrainian relations, discord of a regulatory nature could recur in 2018/2019, given that the transit agreement between Russian and Ukraine expires in 2019. As a member of the Energy Community, Ukraine will have to ensure that the new transit regime conforms to the rules of the Energy Community and the EU's Single Market. Legal and regulatory questions will need to be clarified, including that of an independent operator for the transmission system (the transit pipeline). So interoperability and transparency pose great challenges. Firstly, the region's gas network is still shaped by the legacy of the Soviet Union. Secondly, regulatory disruptions that could inflame the security conflict between Moscow and Kiev need to be avoided. Thirdly, gas exports via Ukraine should be maintained – presupposing legal, technical and economic steps supported by all parties and "gas neighbours". This situation bears risks of spillover into the broader security conflict.

5) *Operation of export pipelines.* The rules, norms and standards developed for transport networks and their operation in the EAEU are also significant in relation to other export pipelines. At the very least, the rules will affect upstream pipelines and interconnectors within the EAEU that link into export pipelines of the EAEU countries. Article 7 of the EAEU Treaty also offers a degree of leeway for external relations. Thus, these are important course-defining decisions for the EU as well.

6) *Desynchronising from BRELL.* Estonia, Latvia and Lithuania are still connected to the Soviet-era BRELL ring, with otherwise only an HVDC connection to the Scandinavian Nord Pool electricity market. In spring 2017 it was decided to synchronise the Baltic states with the European ENTSO-E network by 2025, via Poland. This "BRELLxit" will have considerable economic repercussions for both sides, the Baltic states and Russia/Belarus. The latter have started investing in new transmission lines and expressing claims for compensation. Issues

that will have to be accommodated include the Belarussian nuclear power plant under construction at Ostrovets, which was intended to supply electricity to the EU; nuclear safety issues are also at stake. Another big question mark is Kaliningrad. It remains unclear whether the exclave will be supplied (asynchronously) and/or operated in isolation or connected to Russia by some other means. Particular vulnerabilities could also arise in the transition phase, if processes are not closely coordinated among the affected parties and a desynchronisation is realised unilaterally. Given that the EAEU intends to realise a common electricity market by 2019 it represents an obvious and central partner.

7) *Synchronisation of Ukraine*. At the end of June 2017 the Ukrainian transmission system operator UKRENERGO concluded an agreement with the European Network of Transmission System Operators for Electricity, ENTSO-E, as the first step towards integrating and synchronising Ukrainian's electricity grid with the EU's. Here again, even if synchronisation is a long-term affair (in the case of Turkey it took about ten years), the problem of emerging technical and regulatory barriers at the borders with the post-Soviet UPS/IPS system should be addressed at an early stage, in order to avoid cementing military fronts and de facto borders in Crimea and eastern Ukraine.

8) *Synchronisation and neighbouring countries*. The economic repercussions of (de-)synchronisation processes on neighbouring countries need to be taken seriously. The potential downsides are illustrated by the example of Turkey and Georgia. When Turkey synchronised with the ENTSO-E network, Georgian investments made under the expectation of export opportunities to Turkey became unprofitable. The costs were then reallocated to the Georgian population.

9) *Risky overlaps*. Overlaps between the EU/Energy Community and EAEU exist in regions where "frozen conflicts" smoulder. Georgia is a member of the Energy Community, while Abkhazia, South Ossetia and

Armenia are drawn into the orbit of the EAEU. Yet in pursuit of multivectoralism Armenia is also seeking ties with the EU; Belarus is a member of the EAEU, but has also requested observer status in the Energy Community. The EU needs to find answers to these countries' desires for balance between power blocs. That again speaks for dialogue between Brussels and the EAEU.

#### 10) *Climate and transformation agenda*.

Dialogue and exchange would be especially useful in relation to global climate protection. Here the EU could engage with existing plans: energy-efficient technologies are increasingly important to the EAEU. The interest in exchange on "best and worst practices" in the areas of renewables and energy efficiency is remarkable. Since 2016 the Energy Department of the Eurasian Economic Commission has been discussing questions relating to corresponding (and harmonised) legislation and the introduction of energy-efficient technologies especially in the area of energy infrastructure. Thus for example the oil market programme names the development and enforcement of environmental protections as a joint responsibility. At the moment Kazakhstan is the only member of the EAEU with an emissions trading system.

## Conclusions

It is hard to see why the EU should sideline itself from the emerging energy markets of the EAEU. Interoperability and transparency are increasingly important, not only for the old physical networks but also in connection with the growing application of information and communication technologies (see [SWP Research Paper 4/2017](#)). If the EU wishes to avoid ceding the initiative to actors like Russia and China, and wants instead to exploit its strategic advantages as an integration space, it should gradually seek dialogue at the technical and regulatory level with representatives of the EAEU. In the event that this cannot immediately be transposed to the political level, an EU-EAEU advisory forum could be established,



to include representatives of the European network operators (ENTSO-E and ENTSOG) and regulators (ACER), but also of the Energy Community. In any case dangerous rivalry over integration in the strategic field of energy needs to be avoided. Instead convergence of market areas should be pursued, in order to open up opportunities for political and economic liberalisation and diversification.

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