



## Short communication

## The 2014 Ukraine-Russia crisis: Implications for energy markets and scholarship

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## ABSTRACT

While the 2014 Ukrainian crisis is far from over, policy debates surrounding the standoff between Russia and the United States and Europe already offer some important lessons on the gap between the policy world and the realities of energy markets. In this communication, we will discuss three policy proposals proposed between February and April 2014 as an illustration of the aforementioned mismatch, and explain their broader implications. As we will show, while the energy world is entering the next phase with renewed emphasis on renewables and energy efficiency, and markets for energy becoming increasingly global and interconnected, a substantial number of politicians and foreign policy makers seem to be stuck in a Cold War paradigm. Though things do not necessarily bode well from a political standpoint, the observed tendencies may offer intriguing opportunities for research related to energy policy far beyond the traditional realms of economics and geopolitics.

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While the 2014 Ukrainian crisis is far from over, policy debates surrounding the standoff between Russia and the United States and Europe already offer some important lessons on the gap between the policy world and the realities of energy markets. To provide a short recap: following on the ousting of President Yanukovich by pro-European protesters on Kiev's Maidan in February 2014, Russia seized control of Crimea. Unfolding violent unrest in Eastern Ukraine, Russia gathering troops at the Russian-Ukrainian border and Moscow's lack of commitment to the April 2014 Geneva agreement aimed at de-escalating the situation accelerated tensions between the U.S. and the EU on one side and Russia on the other. The result was the most serious confrontation between 'East' and 'West' since the fall of the Iron Curtain, with possibly long term foreign policy repercussions. Energy featured prominently in policy debates during the crisis.

In this communication, we will discuss three policy proposals proposed between February and April 2014 as an illustration of the aforementioned mismatch, and explain their broader implications. As we will show, while the energy world is entering the next phase with renewed emphasis on renewables and energy efficiency, and markets for energy becoming increasingly global and

interconnected, a substantial number of politicians and foreign policy makers seem to be stuck in a Cold War paradigm. Though things do not necessarily bode well from a political standpoint, the observed tendencies may offer intriguing opportunities for research related to energy policy far beyond the traditional realms of economics and geopolitics.

### 1. Send American Liquefied Natural Gas (LNG) to rescue Europe [1]

The basic assumption is that abundant U.S. shale gas can be exported to Europe and function as a realistic alternative in case of gas supply disruptions following decisions in the Kremlin. The prominent Visegrad Group, consisting of the Czech Republic, Hungary, Poland and Slovakia, asked House speaker Boehner to help fast-track Liquefied Natural Gas (LNG) exports from the United States. They argued that this would enhance European gas supply security and lower gas prices in their countries [2]. The V4 group's proposal received vivid endorsement from members of the political establishment in Washington DC.

By U.S. law LNG can be exported without any volumetric limits to countries that have a free trade agreement (FTA) with the US. Countries without an FTA agreement can also receive LNG from the US, but companies that want to export need to go through a lengthy and costly permitting process with the Department of Energy (DoE)

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and then the Federal Energy Regulatory Commission (FERC). Proponents of more LNG exports have been pushing to speed up this regulatory process [3]. Opponents are concerned that more exports of LNG will have an upward effect on domestic prices of natural gas, and also fear environmental consequences (rising carbon emissions, more consumption and accelerated production and ancillary infrastructure).

The first – and to date only – LNG export terminal that has gone through the entire licensing process is not expected to start exporting before late 2015. Six more companies have received permission from the DoE to export natural gas. If these companies were to leapfrog the cumbersome FERC process (total costs of the licensing process are estimated around \$100 million), it would still take billions of dollars to build new greenfield LNG export facilities or to convert existing regasification terminals. Furthermore even if LNG cargoes would seek export destinations elsewhere in the world, Europe is unlikely to be the market of first choice. This is because price dictates where the commodity is sold, not political desires. Here, simple economics suggest that LNG will flow to Asia, given spreads of 14 dollars or more between the US Henry Hub and Japan's import prices, even if higher shipping costs are factored in. Recent trends in global LNG trade confirm that increasingly trade moves from Europe to Asia, with 75% of trade taking place on that continent in 2013 [4]. Whatever is left in the global market place may go to Europe, but likely at substantial premiums.

What's more, the EU gas market is simply not ready: parts of the continent remain poorly integrated and too often natural gas cannot flow freely through scattered national markets. Market regulations are not harmonized and prices, with the exception of Northwestern Europe, are not formed on a spot basis but remain under heavy state influence, notably in the former Communist bloc. In Bulgaria energy prices remain heavily regulated, and for the same reason the energy sector lacks profitability also in Slovakia. Hungary, in turn, just re-nationalized its gas sector squeezing out Western companies. As a consequence conditions for much needed energy investment remain unattractive and countries continue to be energy insecure and single source dependent.

It is of course true that adding more resources in the global LNG pool – including those from North America – likely have a downward effect on prices of natural gas. It is also true that the United States' rapid shift from a net importer into a potential net exporter has resulted in LNG flows from for instance Africa or the Middle East being redirected to alternative markets, including Europe. US LNG cargoes would, however, do little for the comparatively small and not well integrated markets in Central and Eastern Europe, nor is it conceivable that such a setting would have a very substantial downward effect on prices in those countries (because this is prohibited by the lack of competition in this part of the continent).

This suggests that the case of Ukraine is used as an argument to further the gridlocked domestic American debate on LNG exports from the U.S. to non FTA countries, rather than being a sincere attempt to help out Ukraine. In addition, in parts of Europe it may serve as a welcome distraction from shortcomings in domestic energy policy choices.

## 2. Establish a common European gas purchasing vehicle

Troubled by Gazprom's perceived dominance in European gas supplies, Polish Prime Minister Donald Tusk floated the idea of an 'energy union' [5]. In essence, the idea is that the European Commission negotiates gas contracts on behalf of the bloc, thus uniting European purchasing power and operating as one central commodity manager. This, in combination with an EU solidarity clause, he argued, would 'end Russia's energy stranglehold' on Europe.

Essentially, this proposal would bring the EU straight back to the public utility model of the 1970s and 1980s, with states providing across-the-board coverage of energy services and setting the price. It would run against the entire legal apparatus that the EU has established so far, with several rounds of reform packages aimed at liberalizing gas markets – not to speak of a gas monopsony being at odds with main EU integration principles. In other words, a gas purchasing vehicle would undo 30 years of EU energy market reforms.

What's more, the notion of 'solidarity', while indicating altruistic motives, in essence equals a phenomenon well known from public policy theory: free riding. It implies that some will pay while others benefit – for energy security, lower prices or the costs of physical infrastructure. In this case, the Polish Prime Minister has argued in favor of orchestration and financing of energy infrastructure (which his and other CEE countries would largely benefit from, while Northwestern Europe has a reasonably well integrated market already), but does not want any European interference when it comes to the energy mix. This would leave Poland, and others, with the opportunity to burn substantial amounts of domestically produced coal, even though that is at odds with existing carbon reduction policies in the EU.

It is highly unlikely that a proposal of this nature will take root. The liberal paradigm is hardwired into the EU's institutional DNA, and existing national energy interests (public and private), policies and preferences are too divergent to make such drastic policy reform feasible. Most importantly, however, another central agency for managing supplies (and prices) across the Union would be ill equipped to deal with rapidly changing international gas markets. Current movements away from the incumbent long-term take-off model toward more flexible arrangements in natural gas trade suggest that decentralized solutions likely will be needed to strike timely and optimal deals, rather than sprawling, Brussels based bureaucracies.

## 3. Sanctions targeting Russia's oil sector

As the Ukraine crisis further unfolded, Washington and Brussels floated the idea of targeted sanctions against the Russian energy sector, as a means to hurt the Russian budget and force the Kremlin to cooperate in solving the conflict [6]. Some scholars have been quick to endorse energy sanctions against Russia and suggested a "playbook for sanctions" that could hurt the Kremlin but "leave the energy taps on" [7]. Leaving aside the questionable notion that energy will continue to flow in case of increasingly stringent sanctions targeting the Russian energy sector, the very nature of energy markets presents a number of uncertainties that deserve the most careful consideration.

The oil market is global and integrated, with 90 million barrels consumed per day, and 55 million barrels traded across the world. In this setting it is virtually impossible to carve one of the largest producers out of the market, without significant negative consequences, notably in the form of price shocks. Hence, consumers in both importing and exporting nations will inevitably be hurt. Given the high integration of the European and Russian economies, the bulk of costs resulting from this policy would land on Europe.

Proponents of sanctions often make reference to the case of Iran. But aside from drawing too early conclusions about the success of nuclear talks with Tehran the comparison is flawed. Iran had been increasingly isolated for a period of two decades, long before the U.S. and the EU imposed oil sanctions against the country in 2012. Because of this long trajectory, capital and technology investment in Iran had slowed to a minimum, and thus the country was not producing anywhere near the amount of hydrocarbons that it in

theory could. That made the costs of sanctions easier to bear in a global oil system. The tough financial sanctions made an important if not decisive contribution to break the status quo, as life for the clique around Ayatollah Khamenei became increasingly difficult. While the complex set of issues involved in the Persian case is beyond the scope of this article, it seems oversimplified to suggest that a similar “policy” can be reiterated in Russia, notably in the context of oil market realities and the prominent place of Russia therein [8].

### 3.1. Four new avenues for energy research

As this discussion vividly demonstrates, the proposals coming out of Washington DC or European capitals in the context of Western efforts to ‘contain Russia’ seem to ignore or at least overly simplify the integrated nature of global oil markets and the interdependencies stemming from regional gas market dynamics. While it is premature to draw all too drastic conclusions, this observation raises four salient questions.

First and foremost, how do we explain the mismatch between policy proposals as discussed and market fundamentals in the energy sector? If a function of mislead policy advice, this would call for more pronounced efforts to communicate scholarly results effectively, translate complex findings into easy-to-read outlets and make them available to decision makers to the extent possible.

Second, and more fundamentally, the stand-off between Vladimir Putin’s Russia and the U.S. and Europe challenges conceptions about global governance. A growing interdependence between major producers and consumers, the rise of new energy players such as China and India, and the emergence of new energy agendas (notably energy poverty and climate change) led to an increasingly complex architecture of state-sponsored and non-state institutions governing global energy. Whilst far from being perfect, the global energy governance architecture was to become increasingly rule-based, multilateral and geared toward addressing access and sustainability concerns, in addition to traditional security aspects [9–11]. If proven to be a structural trend, the renewed inclusion of energy in hard-nosed interest driven politics severely puts in question this trend.

Third, and related: having taken interdependence for granted for more than two decades, are we returning to an era dominated by a geopolitical energy paradigm? To be sure, energy has always been a private good with public goods characteristics, hence a highly strategic good for countries and nations for its vital importance for welfare and national security. In a purely geopolitical paradigm, however, energy is subordinated to larger national security goals, and becomes a mere means or an end of state craft and foreign policy [12]. Market arrangements would consequently give way to more state dominated arrangements, in which energy trade is subject to a mercantilist approach to and energy companies resume a key role in pursuing national grand strategy. Whilst certainly not new to the energy world, a return of geopolitics as a dominant energy paradigm would probably put in question the viability of

many of the multilateral arrangements that have emerged over the past decades.

Fourth, what should we make of the position of emerging economies which *grosso modo* abstained from voting on the U.N. resolution on Crimea? Given that the vast majority of energy demand growth in the coming decades will occur in countries in Asia, the Middle East and Latin America, institutional arrangements in international oil and gas will crucially require the consent and involvement of these regions, in order to safeguard the stability of global energy markets, and to smoothly accommodate for new energy gravity centers in the global energy system.

In sum, the Ukraine–Russia crisis may open up various promising routes of research for social science scholars interested in energy. In retrospect we may conclude that this crisis marked a fundamental shift from an era characterized by more orderly market functioning to a less organized scramble for resources as predicted. Novel concepts of security and governance are urgently needed, as they will provide for much needed guidance on where to search for concepts fitting 21st century challenges in global energy.

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