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Oil Companies, Pipelines and Energy Security – Implications of the European Council Summit on Energy

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Energy was one of the main topics at the European Council summit on 4th February 2011. The EU heads of government and state once again declared that "the EU needs a fully functioning, interconnected and integrated internal energy market". According to the declaration of the Council, "the internal market should be completed by 2014 so as to allow gas and electricity to flow freely". This indicates that the necessary natural gas and electricity infrastructure must be built within the next three years and energy security, as a consequence, will increase. Other reports citing Jose Manuel Barroso, however, state that by 2014 only the regulations allowing gas and electricity to flow freely must be adopted by that time, while the infrastructure does not have to be ready as quickly.

Be that as it may, a real obstacle to building cross-border gas pipelines and electricity networks is, in many cases, economics. One often hears prime ministers or heads of state agreeing to build a pipeline between two countries. Moreover, they often reinforce their goals by signing a memorandum of understanding. Many forget, however, that pipelines are normally built by oil and gas companies and financed by banks seeking to make profit on their operations. The participants of the European Council summit admit this and count on the participation of oil companies in these projects when declaring that "the bulk of the important financing costs for infrastructure investments will have to be delivered by the market, with costs recovered through tariffs".

Let us take the proposed North-South natural gas pipeline starting in Poland, crossing Slovakia and Hungary, and finally ending up in Croatia. According to the arguments, natural gas supply security will increase if the pipeline is built. And this is true. Yet one must ask: who is going to build a pipeline only for security reasons? A pipeline can only be profitable if it is used and its users pay for its use. To-date however, it remains unclear who is going to purchase gas from whom with this pipeline and where the gas is going to come from. A possible source could be liquefied natural gas (LNG) from the Northern coast of Poland (using an LNG terminal currently under construction), or from the Croatian island Krk, where the construction of an LNG terminal has been planned. In order to gain financing from the market, long term gas delivery contracts are indispensable. True, recently global gas prices have been far lower than Russian gas. Thus it is currently worth buying gas from global markets. However, since global gas prices can only be forecast with huge uncertainty and the oil-price-pegged Russian natural gas pricing system is less and less stable, it is unclear how long this will be the case.

As a consequence, it is very risky for both buyers and sellers of LNG, to sign long term contracts. Fortunately, interconnecting Central and East European (CEE) gas networks is the first step so that countries of the region can also buy natural gas from Mediterranean producers. Croatia has a pipeline connection with Slovenia. And Slovenia has a connection with Austria and Italy as well. Moreover, gas flows are directed towards Croatia, allowing it to import gas from the Italian ENI. Increasing the capacity of these connections and linking the Croatian and Hungarian gas networks makes it possible for countries which export gas to Italy (e.g. Algeria) to sell their gas in the CEE region. In this way, the Visegrad countries can diversify their natural gas imports and, more importantly, create competition with Russian gas, which could result in lower prices. In our view, this is the most important result of interconnecting the gas networks of Central and Eastern Europe. This interconnection, along with the enhancement of Italy-CEE gas supply capacity, ensures there will be gas in the pipelines and that interconnection will become a profitable enterprise. Profitability can be further enhanced by the fact that the European Council, implicitly, has turned a blind eye to possible increases in gas transport fees.

A new element in the declaration of heads of government and state is that "the High Representative is invited to take fully (sic) account of the energy security dimension in her work." To understand what all this can (or perhaps *should*) include, we first take a look at the international oil and gas industry landscape.

In the past decade, competition for oil and gas reserves has strengthened, with many new players entering the international oil and gas markets, in particular resource seeking national oil companies (NOCs) from developing economies. By gaining exploration and production rights, these NOCs have recently expanded operations internationally and enhanced their capabilities in the exploration and production of hydrocarbons. Paying closer attention to how these companies have garnered some measure of market success is instructive.

First, in bidding for oil production rights, NOCs often offer more than just money. They offer the construction of infrastructure and development of the host economy as a whole in order to obtain oil production rights ahead of other international oil companies (IOCs). NOCs (or their home countries) offer "development aid" to countries rich in hydrocarbons in exchange for oil and gas production rights. This development assistance approach differs significantly from the Western approach to aid and seems to represent something of a success story, in particular for China.

Second, NOCs are ready to undertake operations in countries which, due to embargoes, are inaccessible for Western companies (e.g. Sudan, Myanmar, Iran). By making use of the political ties between the home country of the NOC and the host country, the respective NOC can become a preferred partner in the host country's oil and gas projects.

Third, the so called market economies of the CIS region, the Middle East or the Far East are not Western style market economies. In the regions mentioned, big oil and gas deals are very explicitly agreed at the highest government level and the related companies only make the deal afterwards. In the Western countries, it is less common to make a deal in this way.

As a consequence, the European Union and the oil and gas companies operating in it now face a competitive market in which other players (the NOCs) enjoy the backing of their home governments (by using political ties to offer development aid in exchange for oil and gas production rights) and face fewer obstacles (such as embargoes). In our view, European oil and gas companies would be more than happy to receive similar forms of assistance from their home governments. Such assistance could be an effective instrument for increasing European oil and natural gas supply security. This is the task the European Council could and perhaps should invite the High Representative to perform.

The examples are clear: the Chinese government helps the Chinese national oil and gas corporations (CNPC, Sinopec, CNOOC), the Malaysian government assists its national flagship (Petronas), the European Union offers assistance to the European flagship oil and gas company. But which company should this be? BP, Royal Dutch Shell, or perhaps Total? And only because their headquarters are based in Europe?

In order to increase oil and gas supply security, some effective government assistance would be an advantage for the European IOCs. But as there is not an EU oil and gas company, this is hard to do.

Recent research has proven that national oil companies also have non-commercial objectives. The interests and objectives of NOCs and their home governments often mix with each other and this is why non-commercial objectives are involved in oil and gas investment decisions. Energy security costs money and this is the burden governments of the emerging economies are ready to shoulder. Based on the European Council declaration, this will not happen in Europe. But if profit-oriented companies understandably are not prepared to carry out (unprofitable) projects to enhance energy security in Europe, Member State or EU subsidies should be made available. Without this, the unfortunate result may be that energy security will increase only very slowly, if at all.

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