Much of the blame for the lack of greater Central and Southeastern Europe (CSEE) energy cooperation can be laid at the feet of the large EU member states who seek closer energy ties with Russia, along with the lack of support from the European Commission, which has so far hindered regional cooperation.

Nevertheless, by far the biggest obstacle to collaboration and more effective resistance to Russian pressure is the lack of sufficient reform within the CSEE countries themselves. Their vulnerability to energy coercion and questionable agreements with Russian leaders in large measure stem from the lack of transparency in their own governments. In addition, there are regulatory, licensing, and taxation issues that have to be tackled by each of the region's governments in order to effectively implement the funding programs approved by the European Commission. Investment laws have to be adopted in order to attract foreign energy investors—those who follow the best business practices and who bring the most innovative technology into the country. They need to attract foreign firms who intend to stay involved in the long term, and they must not act as future sales agents for nontransparent firms representing Russian interests.

The situation, however, may now be moving in a more positive direction. The intergovernmental group that was announced at the February 24, 2010 Budapest energy summit could be put together quickly and should include the best energy policy specialists from each of the 11 participating states. The group should be given broad authority by each government to implement the best practices in developing domestic and cross-border projects. Total transparency should be required of the group in order to prevent nontransparent or corrupt local business interests from overriding the need for regional energy security. Openness is also needed in order to combat efforts by supplier nations to subvert the goal of greater regional cooperation. It will be a difficult task to harmonize totally the energy activities of 11 nations, but a high degree of combined action should be possible, particularly if it has strong political support from member governments and it is allowed to reach out to international banks and development institutions for technical and financial advice.

Effective use of this intergovernmental group would likely increase the region's influence within the European Commission's Directorate-General for Energy and with the commissioner for energy. Strong and effective support from member governments could persuade Russia's closest energy backers in the European Union (Germany, France, Italy, and Austria) to pay greater attention to investment opportunities and even to the energy security needs of the region. Most importantly, the kind of cooperation envisioned at Budapest would increase the weight of the CSEE countries on a wide range of energy security issues, including the formation of a common energy market and the enforcement of competition and antitrust laws that are now openly flouted by several of the larger states. An intergovernmental commission, however, cannot resolve many of the most important impediments to regional cooperation. Under international law, two countries cannot link together their energy transmission systems without a formal state-to-state agreement. Several countries that want to build gas interconnectors with EU funding have not yet reached agreements with their neighbors. Even Hungary and Romania, which plan to tie part of their pipeline systems together, do not yet have the required

intergovernmental agreement, which has caused some delay in completing the interconnector. This is one area in which a nudge from the Directorate-General for Energy could help move things along.

All EU members are already subject to the rules contained in the Energy Charter Treaty. And yet, several member states have taken no action to force their domestic firms to open their pipelines as “common carriers” so that multiple companies would have access to spare capacity. Doing so would increase competition and efficiency, and would ultimately lower prices for the consumer. Unfortunately, several of the larger EU members, such as France and Germany, have resisted both unbundling and a common carrier system, but this should not prevent the CSEE countries from moving ahead on their own.

A stable regulatory and licensing system that covers pipelines, LNG facilities, and nuclear plants, as well as pricing and environmental concerns, is also a must. The challenge is to devise a regulatory system that encourages, rather than stifles, competition and that is transparent without tying projects up with endless political conflict. The United Kingdom’s energy regulatory system is a good model for the new democracies, as is the US Federal Energy Regulatory Commission, although the United States has a separate agency for oil and nuclear plants. Both countries appear to strike a reasonable balance between promoting open energy markets and being able to protect the interests of the consumer. Governments should provide a regulatory framework and not try to “manage” the market. All of the countries must avoid the temptation to regulate consumer prices to the benefit of either producer or consumer groups, rather than have them reflect the real market price of the final product.

Although for political reasons many governments are reluctant to publicize negotiations with non-EU or non-European energy suppliers, the European Union has so far refused to require greater transparency. The CSEE states could take on this challenge. It would prevent the smaller and more economically vulnerable countries from being played off against each other by phantom promises of future riches made by supplier states, such as Russia. The history of Russian negotiations with CSEE states regarding participation in the South Stream project and possible benefits to individual countries is a good example of why greater transparency is needed in bilateral discussion involving energy deals. The shrouded negotiation between Croatia and Russia regarding the Druzhba pipeline and the pipeline from the Krk Island LNG facility is a good case in point. Both pipelines are controlled by a Croatian company that is independent of Hungary’s MOL. The unspoken goal of Gazprom appears to be one of shutting off competition to Russian oil and South Stream gas by limiting shipments to Central Europe through Adriatic ports. After Gazprom’s takeover of the key NIS oil refinery in Serbia, a Croatia-Russia deal would pose a significant danger to CSEE energy security. Although the Croatians deny that they are “breaking ranks” with their CSEE neighbors on energy security, they have agreed to Russian suggestions that they support the South Stream pipeline in return for possible economic benefits, such as insuring that the pipeline would pass through Croatia to the gas storage terminals in eastern Austria. Even if South Stream never materializes (a good possibility), Russia will still be in a strong position through its control of Croatia’s pipelines from the Adriatic.

The Croatians are not the only CSEE country to sign up for South Stream while at the same

time declaring their support for Nabucco. Austria, Hungary, and Bulgaria have agreed to participate in both pipelines. There is not sufficient gas demand for both pipelines, and it may appear prudent for governments to hedge their bets on which pipeline (assuming one of them is built) can demonstrate that it will be constructed and be the first to bring new gas supplies. Not only are there supply questions regarding Nabucco, but in addition, Turkey's demands for effective control of the gas and its touchy relationship with Azerbaijan has stalled the project. At the same time, Russia's South Stream project shows even fewer signs that it can supply the necessary gas volumes. South Stream's reported $26-billion construction costs stimulate the question whether the project is only being put forward in order to kill off Nabucco. Only Italy appears to claim that it is a serious proposal to supply the region with new gas supplies. Russia also sees South Stream as a means of putting pressure on Ukraine to turn its pipeline system over to Gazprom.

Recently, Russia and Turkey have floated the idea of Gazprom becoming part of the Nabucco project, with Russian gas from the Blue Stream or a possible new Russia-Turkey pipeline contributing a large share of the gas. The difficulty with such an option is that Russia has never been content to play a minority role in any of its pipeline deals. It should be assumed that even if Gazprom were to take a minority and non-blocking share of Nabucco ownership at the beginning, it would, within a short time, start applying pressure on other partners to sell their shares to Gazprom, until it acquired a majority, or at least a blocking position in the consortium.

A look at Baltic cooperation: slow but steady on regional integration

The "energy island" countries of Estonia, Latvia, and Lithuania are nearly 100 percent dependent on Russia for oil and gas imports, reflecting the legacy energy policies of the former Soviet Union. The three Baltic states have been a prime target for Russian energy supply disruptions for the past 20 years. An oil cutoff was used by Moscow in 1990 in an attempt to stifle the region's new independence movements. In 1992, in a futile effort to keep the Russian officer corps stationed in Estonia and Latvia, energy supplies were again shut off in the middle of an especially cold winter. Oil shipments to Lithuania were disrupted nine times between 1997 and 1999 in an attempt to influence negotiations over ownership of an oil refinery. Russian oil shipments through the Druzhba pipeline have now been permanently stopped to Latvia and Lithuania (both EU member states) as a result of these two countries' unwillingness to sell their pipelines, oil ports, and refineries to Russian companies cheaply (or at no cost). Gazprom has succeeded in gaining control of the natural gas companies of all three Baltic states, along with ownership of power plants in Latvia and Lithuania.

Surprisingly, few Western Europeans are aware of the extensive use by Moscow of energy coercion in the Baltic states, even though more than 25 politically motivated disruptions have occurred in the past 20 years. These tactics by the Kremlin have been widely documented but have attracted little attention in Germany, France, Italy, or Austria—Moscow's closest energy partners in Europe. Requirements imposed on the three Baltic states as a condition for EU membership, such as the premature closing of the nuclear power stations in Lithuania, have made it certain and unavoidable that in the short term the three countries will be more, rather than less, dependent on energy supplies from Russia.

Since the mid-1990s, there have been numerous meetings among officials of the Baltic states in

an attempt to adopt a coordinated response to Russian pressure and a strategy for enlisting more support from Western Europe. In addition, a Baltic States Energy Forum is held each year in one of the capitals, with representatives from the United States joining officials of the three governments. The goal of the forum is to draw up realistic proposals for greater regional energy cooperation and diversity of energy import sources.

Although there have been repeated meetings at the governmental and nongovernmental level, progress toward greater regional energy cooperation has been slow. Nevertheless, there has been development toward establishing a common electricity market that would cover the three Baltic states. Lithuania has even introduced an electricity exchange, in which 43 percent of the country's domestic electricity use is now traded. Electricity exchanges in the other two countries would advance considerably the prospects for a real common Baltic market for energy. With the help of Sweden and Finland, construction of a Baltic-wide power grid is under way, linking the three Baltic states' electricity systems with those of Poland and the two Nordic countries. Estlink I, the first electricity inter-connector between Estonia and Finland (350 megawatts) was completed in 2007, and a second line (Estlink II) with a capacity of 650 megawatts will likely be completed in 2013–2014. In times of need, the three Baltic states will in the future be able to draw on excess electricity from Finland, particularly when Finland's two newest nuclear power plants go on stream in the next few years. Another significant development has been the signing in early February 2010 of a deal between Estonia and the Norway-based regional electricity bourse called Nord Pool, with the aim of creating a single Nordic and Baltic owner market by 2013. The latest agreement allows Nord Pool to expand its connections with Latvia and Lithuania. Until February, the Baltic–Nord Pool agreement provided only for electricity ties with Estonia manifested through Estlink I.

The European Union has approved funding of a large-capacity electricity inter-connector between Lithuania and Sweden, and the governments of Latvia and Estonia have agreed to the arrangement. It also appears as if the long talked about "power bridge" between Poland and Lithuania will be constructed in the next five years. All of these interconnectors are designed to work in two directions. Nevertheless, there is some uncertainty whether a new nuclear power station will ever be constructed in Lithuania to replace the two reactors that were shut down, the last at the end of 2009. The Baltic states have been discussing for the past five years the common use of power from a new Lithuanian nuclear reactor. The project's delays, however, only add to the energy insecurity in the region. Russia's announcement that it will construct a nuclear power reactor in the small Russian enclave of Kaliningrad and that it will sell excess electricity to neighboring states appears to be an attempt to weaken support for constructing a new Lithuanian reactor.

Within the Baltic states there is growing interest in importing LNG in order to compete with Russia's present gas monopoly. There is the inevitable competition among the three countries regarding where to establish the LNG gasification plant. Lithuania seems to have taken the lead over Latvia, by securing funding in 2008 from the US Trade and Development Agency for an $800,000 feasibility study for a plant located on the country's Baltic west coast. One Polish energy planner, however, voiced a preference for a plant in Latvia, arguing that an LNG receiving plant located at the port of Ventspils could serve to ship the piped gas more easily to the three Baltic markets.

In any case, with the Baltic economies only slowly emerging from a deep recession, it is difficult to see how a proposed LNG plant could secure the necessary financing in the near term. One Latvian businessman has discussed with Qatar the possibility of that country financing an LNG port with the guarantee that the three countries would take enough gas to make the venture profitable. It would be very difficult, however, to persuade the three governments to agree to this formula—and to overcome the inevitable opposition of Gazprom, which at present controls the gas distribution systems in the region. Surprisingly, the Latvian branch of Russia's Itera is supporting the idea of building an LNG plant in Latvia. Since Itera relies on Gazprom for its product, this may simply be an attempt by Gazprom to control any possible competition or to discredit the deal.

Another plan, with better prospects, is the attempt to reach an agreement among the three countries on the construction underground of additional gas storage facilities. Currently, the largest underground storage facility is in Latvia and is controlled by Gazprom. The firm uses gas imported in the summer to supply the St. Petersburg area during periods of peak demand in the winter. A new and larger Baltic-wide storage facility, including a revised financing formula, would have to be agreed upon by the three governments in order to construct new facilities. This project is already receiving funding for a feasibility study by the European Union, and it might receive construction funding as part of the European Union's next energy facilities funding package. Latvia is the only Baltic state that appears to have enough underground cavern space for constructing new storage facilities, although Lithuania is financing a new geological survey that will examine possible storage sites in that country. In any case, the region is under pressure by the European Union to increase significantly its gas storage capacity; in itself, this is a positive step.

One roadblock that has defied resolution for the past 15 years is the demarcation of the sea boundary between Latvia and Lithuania. An intergovernmental agreement has been signed between the two states and has been approved by the Lithuanian parliament. However, its prospects for passage in the Latvian parliament are not good. This is a serious setback, since there is good reason to believe that profitable quantities of oil and gas lie offshore in almost the entire Baltic Sea basin. The Chevron Company of the United States was ready to begin exploratory drilling in the disputed zone in the late 1990s but pulled up stakes after it became apparent that the two countries were far from reaching a sea boundary agreement. Even the possibility of significant tax revenues has not been enough incentive to break the legal and political logjam.

Meanwhile, Russian companies have already been drilling off Kaliningrad, and while the results have not been made public, it is reasonable to assume that significant amounts of gas and oil will be found there. Polish seismic work in the Baltic basin just west of the Kaliningrad offshore economic zone indicates that there are reasonable prospects for commercial exploitation of some oil and larger quantities of gas. Therefore, the failure of the Latvian government to ratify the most recent treaty is a major disappointment to those hoping for some relief from the tight grip that Gazprom has over the gas markets of Latvia and Lithuania.

Lithuania proposed in November 2009, at the NATO Industrial Planning Committee, the establishment of a NATO Energy Security Center of Excellence, with a possible location at a

university in Kaunas, Lithuania. Although Lithuania has been floating the idea for over a year, it has not been able to gather enough support from other member states. It is difficult to ascertain how much opposition is coming from countries like Germany that oppose any NATO role in energy security. In order to move ahead, the proposal would require a strong push from the United States and several other key NATO members.

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