

## **South Stream's Cancellation: The End of a Saga<sup>1</sup>**

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On December 1st, Russian President Vladimir Putin made a surprising announcement in Ankara that his pet project, the South Stream pipeline, would be cancelled due to EU opposition. Indeed, the European Commission (EC) had refused to grant South Stream the demanded exemption from the norms of the Third Energy Package – “ownership unbundling” and “third party access” –, a demand that Gazprom sought to justify through the project’s supposed “strategic importance to the EU energy security.”

Before briefly examining the reasons of this unexpected turn of events and its likely effects, let us first recollect South Stream’s history. The project was initially announced by Mr. Putin in 2007, in the aftermath of the first “gas war” between Moscow and Kiev (January 2006). In its first stage of politico-diplomatic existence, South Stream mainly served as a means to undermine its main rival project, Nabucco – back then the flagship project of the Southern Gas Corridor (SGC), but eventually discarded in June 2013 in favor of the Trans-Adriatic Interconnector (TAP). In effect, with Romania’s exception, one by one, every government that had signed Nabucco’s intergovernmental agreement jumped on South Stream’s bandwagon, too.

Apart from sapping Nabucco, the South Stream idea also served as a coercion lever against Ukraine and its ability to interrupt Russian gas flows to European markets. In the current context of Ukrainian crisis, Moscow has stepped up efforts to turn South Stream into reality and completely bypass Ukraine as a gas transit territory.

Nonetheless, South Stream would have been very expensive to implement – no less than €30bn overall – and Russia’s ability to foot such a bill has been drastically affected by the oil price fall since June 2014, as well as by Moscow’s exclusion from the Western capital markets, as a part of the West’s economic sanctions. Moreover, against a

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background of glacial relations between Moscow and Brussels, the EU authorities have refrained from even holding talks on South Stream's fate.

Certainly, not all EU member states see eye to eye on the South Stream issue. Several EU countries – notably Bulgaria, Hungary, Slovenia, and Austria – were to be crossed by the pipeline, while Italy was a supporter mainly for corporate reasons, given the involvement of Italian companies ENI and Saipem in the project. Yet these governments could not garner the hoped for level of support in Brussels. Indeed, Bulgaria had to stop construction works on its national section following injunctions from the EC related to competition rules.

In Ankara, President Putin and Erdogan signed a memorandum of understanding concerning the development of a natural gas hub in Turkey, to which Russia would direct the gas volumes currently transited through Ukraine. For Moscow, this is a way of forging a needed partnership with a regional power in a time of virtual exclusion from political relations with the Western world; it also means access to a major and growing gas market and, of course, a way to circumvent Ukraine's territory. For Turkey, it offers an enhanced prospect to become a world-class gas hub, as several major conduits from Russia, the Caspian Basin, and the Middle East are bound to meet in Turkey in a few years' time.

Russia agreed to raise capacity on the Blue Stream pipeline (which connects Beregovaya, on the Russian Black Sea coast, to Turkey's Samsun) from currently 16 bcm/year to 19 bcm/year. As of 1 January 2015, Turkey would receive a 6% price discount for Russian gas, and Vladimir Putin said Gazprom was ready to provide Turkey with additional gas – initially 3 bcm/year.

Nevertheless, it remained unspecified whether the construction of a new pipeline was necessary and, if so, what route it would take, what parameters it would have, how it would be financed and how it would be operated.

In a TV interview a few days later, though, Gazprom CEO Alexei Miller did refer to a new undersea pipeline of 63 bmc/year capacity that would use the already constructed South Stream infrastructure in Southern Russia and the pipe segments stocked in Bulgaria. He also referred to “the trading platform on the Turkish-Greek border.” Characterized by such elements, the new pipeline (let us call it South Stream 2.0) would basically be a redirected South Stream with the landing point of the subsea section translated from Varna (Bulgaria) to somewhere south of the Bulgarian border, on the Turkish south-western coast of the Black Sea.

It will take years before the agreement in principle will have been worked out into a detailed commercial deal. Yet let us explore here some potential strategic consequences of this scenario. Such a landing point is bound to be close to the Turkish end of the TAP pipeline, planned to run over northern Greece, Albania and under the Adriatic Sea to southern Italy. As TAP is to become the final segment of SGC – a complex and expensive gas transport system that endeavors to ship Caspian gas to Europe – South Stream 2.0 could just as well tap into TAP (no pun intended) and use it to transport Russian gas to European destinations.

This would be a direct interference of Gazprom with SGC's strategic sense: to supply the EU with non-Russian gas through a conduit not controlled by Russia. Actually, Gazprom would be able to largely control a new gate of gas deliveries to Europe's South and South-East. This would be bitter irony indeed, given SGC's huge estimated costs (about \$50bn overall) and the political effort it has taken to achieve its final configuration. Therefore, South Stream 2.0 could end up not only achieving its longstanding goal of bypassing Ukraine, but also spoiling the rationale of one of EU's main diversification projects.

For its part, Turkey will benefit from abundant and cheaper gas supply for its domestic economy, as well as from hosting a very well-provided gas hub next to its metropolis. TAP will run at full capacity, so its transport cost per thousand cubic meters will be minimized. Similarly, TANAP will be able to ship ample gas volumes both from West-to-East and vice versa.

Azerbaijan's situation will be somewhat trickier: while the additional Russian gas would increase the efficiency of SGC's transport services and diminish network costs, Baku's market share in the EU will be under threat. The price policy and the contractual terms offered by Azerbaijan will probably have to be more flexible than without the competition of Russian gas, as profits will also stem from lower transport costs through SGC. At the end of the day, all the state and corporate actors along such a redefined SGC will likely learn to accommodate each other and work together, in spite of occasional rivalry and friction.

TAP's own transitory exemption from the Third Energy Package's requirements would no longer be justified from the moment South Stream 2.0 entered the SGC. In effect, the new Russian pipeline would join a transport system aligned to the Third Energy Package standards on the EU territory. But then again, Gazprom could have achieved a very similar situation with the initial South Stream project, had it agreed to play by the Third Energy Package rules in the first place.

No doubt, the South Stream 2.0 scenario is still a long shot. Among its determinant factors is whether Moscow's and Ankara's strategic interests align and persist along this axis. After all, Gazprom has no interest in entirely replacing one major transit state (Ukraine) with another one (Turkey) in Russia's export routes to Europe. At the same time, Ankara has no interest in becoming overly dependent on a supplier so well-versed in the art of energy diplomacy.

While Moscow and Ankara seek to stand by each other in their drift away from the EU norms and values, theirs is a manifold relation, in which they have often pulled at cross purposes. In recent history, it suffices to recall the political clash between the two countries surrounding the construction of the South Caucasus Pipeline (Baku-Tbilisi-Erzurum) for natural gas and the Baku-Tbilisi-Ceyhan oil line. At present, Moscow and Ankara still defend fundamentally opposed stances about the conflicts in Syria and Iraq.

Otherwise, Turkey has recently proven its willingness to take advantage of the Russian embargo on fruits and vegetables imports from the West (imposed in retaliation to the latter's own sanctions) by stepping up its own supplies.

Prudential considerations on both sides render it unlikely that South Stream 2.0 will be built at full capacity on the medium term. Rather, we will probably witness an incremental development of the gas trade across the Black Sea over the next years.

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