

KEEP CALM AND CALL OUT PUTIN'S BLUFF ON GAS

The case for capping the Russian gas price



Despite the generalized panic, the EU has a very strong hand against Russia when it comes to gas. In reality Russia cannot play the game of selective cuts for long. The EU can rally all its members and dissenting voices in a joint, effective containment of Kremlin's gas blackmail by a EU-wide cap on Russian gas prices, coupled with a simple solidarity mechanism.

Gazprom's gas blackmail on key European countries and companies is paying off: the threat of total cuts of supplies by winter leads to generalized panic for decision-makers and the public. In reality, **Kremlin's remaining gas leverage over the EU is close to zero from summer to end-year.** Gazprom has played until now with gas cuts targeting individual clients or countries to push spikes in spot prices on EU markets, cashing in large amounts from the remaining long-term contracts which are linked to spot prices. This is why Russia makes more money now from gas than last year, despite the reduction of quantities delivered.

The urgency is thus to 1) understand how much Gazprom can play this game for the rest of the year and 2) devise a sanction which keeps all the EU united.

1) The Kremlin cannot afford to further cut gas supplies to all EU for the rest of the year and not even for a few months in winter. The physical limitations of what Russia can do could be observed last year, when Russia manipulated gas markets in

the EU by depleting gas storage in Europe. It could do so only because Russian domestic storage in spring 2021 was at a historical minimum (about 15 bcm), filling it to 99% (72.6 bcm), by end-year; consuming more at home with the post-pandemic recovery; and exporting to the maximum of available physical capacity elsewhere, in a context of global high demand (still, such exports are below 80 bcm).

One must keep in mind that, though the EU has been importing until 2021 about 40% of its gas from Russia, in its turn **Russia is much more dependent on the EU.**

Overall, with some 155 bcm per year, the EU used to represent 30% of Gazprom's production (70% of its exports); or 20% of Russia's total gas production and 55% of Russia's exports. But already in the first half of the year EU's imports of Russian gas halved - meaning that **by end-June, EU had already reduced by 30 bcm the imports of Russian gas compared to last year.**

Let's add up the probable figures for this year. Russia's gas production - about 760 bcm in 2021 - remains rigid. It can be stored; sold internally; or exported. Only as the last alternative, and if nothing else works, can the production be reduced. Shutting down production means huge costs (one needs to shut down wells, while pipes that are temporarily out of use corrode rapidly). It involves other huge costs, plus several years of work, to restart the production later, if there's demand. **This is why the embargo on Russian gas, discussed earlier this year, would have been such a tremendous blow for the Kremlin** (and this is also why the reduction of global gas consumption during the pandemic led to havoc on international gas markets in 2021).

The excess gas that Russia would now not sell to the EU:

- cannot be stored beyond Russia's available storage of 73 bcm. Though Russia no longer publishes any kind of data, it is certain that storage this year by end-Q1 could not be less than the 15 bcm it had in spring 2021. It would be more likely at least 40 bcm as in regular years, but probably significantly higher, up to 50 bcm, because Russia entered the winter with its gas storage full and

the winter was mild. Still, let's assume a conservative 40 bcm. **Only the 30 bcm foregone by the EU so far, without any additional cuts and without any additional storage from ongoing domestic production, would likely push already the available Russian storage capacity to the limit.** The 30 bcm represent foregone deliveries for the entire year by Gazprom's unilateral breach of contracts so far, but at least 60-70% of it would have been delivered to the EU before end of the storage (injection) season. In the meanwhile, Russia must store also its ongoing domestic production over the summer, if it does not shut it down. Thus, adding up the numbers, it is impossible that Russia can keep the balance even now without having to shut down some production.

- It cannot be pivoted fully to Asia or other places in 2022. Russia can export this year no more than 40 bcm by LNG, 27 bcm to Turkey by pipeline and 10 bcm to China, the capacity it already used to the maximum in 2021 to redirect gas away from the EU. Russia's planned diversification of exports is a solution, but not this year. **Russia cannot increase this year the export capacity elsewhere; it may be able to do so by 2025 or 2030, but not in 2022.**
- It cannot be consumed internally when the economy under sanctions drops by at least 10% (industrial consumption even more). The 2021 domestic consumption was 475 bcm. Probably at least additional 40 bcm of production would have either to be reduced or stored.

All in all, in front of a united EU, Russia would already have to shut down at least 40 bcm of production to compensate for the reduction of domestic consumption, and possibly 10 bcm to compensate for the fact that less gas must have been taken out of the storage last winter because of milder weather. Otherwise, the cuts so far of supplies to the EU have already reached the physical limits of the Russian gas system.

2. Keeping the EU united. The above calculation is valid and can be used effectively against the Kremlin and Gazprom only if the EU remains united. Otherwise,

Russia could on one hand still bluff and threaten EU clients and countries or, on the other hand, find ways to sell some of its excess 40-50 bcm to individual EU countries or consumers and divide Europe even more.

The way to do it is by **imposing a EU-wide price cap on imported Russian gas**.

Given Russia's constraints, the **price could be set quite low, e.g. even at 2020 levels**; Russia's alternative is much more costly. Imposing an EU-wide price cap can be legally enforced as a **sanction**.

- Gazprom has unilaterally breached individual contracts by cutting supplies or asking for payment in rubles. For example, the cut of deliveries to Germany is in no way justified by the maintenance of Nord Stream 1 - the same quantity could have been easily supplied via the older Ukrainian route. Given Gazprom's behavior and breach of existing contracts, there is no legal reason why the EU cannot impose a EU-wide price cap for ongoing contracts, which can also be devised as a sanction.
- The main division in the EU, as well as dissatisfaction of EU citizens, is related to uncertainties on gas prices and availability for the winter. Devising a mechanism to keep prices low - such as the price cap on Russian gas imports - is the simple, effective way to keep consumers calm and not lose focus on the tragedy unfolding in Ukraine.
- In parallel to the price cap, a stronger solidarity scheme must be put in place across the EU. Gazprom cannot afford to cut all supply to the whole EU but can continue to do so for short periods for individual countries to create panic and seed division. Put simply, EU member states must commit to providing immediate assistance to such a country by neighbors compensating the missing quantity on the spot. The quantity could be then returned by the country thus supported immediately when the supplies are resumed. **Such a scheme would simply deter Gazprom from cutting supplies in the first place**. As explained, since the quantities that Gazprom could play with are marginal,

there is no risk of a serious gap in supply for the entire EU as long as it shows a united front.

- **Imposing a EU-wide price cap on Russian gas at the 2020 level would keep all populists across Europe at bay**. There is no way in which a Viktor Orban, for example, could single-handedly negotiate a better deal with Gazprom. The price cap will rally the entire EU in opposing Russia's gas abuse, achieving a "stable equilibrium".
- Last but not least, it will immediately slash Kremlin's revenue from gas. This is not only useful to break Putin's ability to finance the war, but is simply morally just, rallying once more Europeans around core values.

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