

Working Paper

Research Unit Global Issues

Stiftung Wissenschaft und Politik
German Institute for International
and Security Affairs



Enno Harks

Transnational Cross-Ownership Schemes in Energy Sectors

A Tool for Increasing Energy Security

Paper prepared for EastWest Institute's Energy Experts & Private Sector Recommendations for G8's Focus on Energy Security, June 2006

EWI publication forthcoming

Working papers are papers in the subject area of a Research Unit, which are not officially published by SWP. These papers are either preliminary studies that later become papers published by SWP or papers that are published elsewhere. Your comments are always welcome.

Ludwigkirchplatz 3-4
10719 Berlin
Telefon +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

Working Paper FG 8, 2006/05, August 2006
SWP Berlin

Content

Introduction	3
Interlinking ownership and interests	3
Practical considerations	4
Conclusions	5

Introduction

Energy security has been promoted by world events to the top of political agendas throughout the world and the G8. Much discussion in consuming as much as in producing nations has been devoted to the question of how sustainable and secure energy can be supplied to world markets, as it is becoming evident that this will be the crucial question for economic wealth and sustained future growth. Several issues around sustainable energy and supply security have come into focus, most notably the questions of market access to energy resources (ie. can energy production infrastructure be kept at sustainable levels if not allocated by market forces?) and transnational energy transit issues (ie. how can a reliable framework of energy cooperation be established concerning transit issues?). Both aspects of energy security have been discussed in depth in the framework of an East-West-Institute (EWI) expert forum, concluding in a number of recommendations to be presented during the G8 Focus on Energy Security 2006¹.

Both questions highlight the importance of cooperation versus confrontation – producers, consumers and transit countries alike have a common interest in aiming at cooperative approaches proving to be win-win situations for all participants. Deepening the integration between producing and consuming nations will ultimately blur the line of separation and cross-link international / energy interests.

One important means of attaining this goal could be the installation of transnational cross-ownership schemes between the consumer country's downstream market and the producer-country's upstream companies. Interlinking company interests on both sides not only deepens the integration of the two markets, but it especially reduces the risk of energy supply disruptions due to one-sided political interests and/or a supply shortfall due to the lack of needed investments. Strong downstream interests of the producer and upstream involvement of the consumer will

provide for a mutually beneficial environment where such situations are of less probability. A discussion of the issues at hand in the realization of such schemes is presented here.

Interlinking ownership and interests

Energy production throughout the world today is still mostly divided: on the one hand, the producer country extracts the resources and transports these to the border while on the other hand the consumer country's companies receive the quantities contracted at the border, pay the import price and take care of downstream infrastructure and sale to the end-customers. While it is true that both parties are dependent on one another for the sale of the energy supply², the situation creates an atmosphere of entrenched positions of diverging (and sometimes mutually incomprehensible) interests on various levels. Both parties follow their own interests, only vaguely acknowledging the fact that these are deeply intertwined with the interests of their counterpart. Simple examples can be the question of price and production/consumption levels.

Hence, allowing for cross-ownership of upstream energy production companies in producer countries with downstream companies in consumer nations allows for converging interests of both parties. The producer's participation in the downstream sale of the resource fosters his interest in a stable and reliable production/supply, as his financial advantages get extended from the border-price sale to the downstream profits in the consumer country. Likewise, the consumer nation's company is involved in decision-making concerning price issues and, more importantly, obtains access to the resources of the producer country and may foster investments in upstream projects. Thus, swapping ownership stakes allows marrying issues of access to energy resources with those of access to downstream markets.

² The supplier is dependent on reliable sale of his commodity for financial reasons, while the consumer needs the resource for consumption. Both parties are especially dependent on one another in the case of natural gas (unlike crude oil), where sunk pipeline infrastructure makes alternatives impossible in the short-term.

¹ See the Global Security Program, *Energy Security and Cooperation* on www.iewis.org.

Energy security can greatly benefit in such an environment, making a disruption of energy supplies or a threat thereof less likely. Domestic lobbies in producing countries will soon emerge taking into account their stakes in downstream markets which will increase opposition to a potential political supply disruption or a threat thereof. As a consequence, domestic energy policy on both sides will be paying more attention to non-domestic considerations – even more so than is the case today.

At the same time, swapping ownership shares between producer and consumer allows for a redistribution of resource rents and risk-sharing: the consumer nation receives a share in upstream equity gas and concomitant production rents, and the producer nation receives significant downstream assets and profits. At the same time, such joint venture in resource exploitation generates a more equitable distribution of risks associated with investment and price movements as both parties are exposed over the entire value chain.

Practical considerations

Examples of cross-ownership schemes between consumer and producer are not abundant, mostly due to political (national) considerations on both sides. However, the German-Russian cooperation agreement forming Wingas can be cited here. This Wintershall-Gazprom joint venture, originally dating back to 1993 in the height of the collapse of the Soviet Union, today is one of Germany's largest gas importing, storage and distribution companies. Gazprom was originally invited to participate with 35% in the venture mainly to market Russian gas in Germany.

After a decade of successful operation in which Gazprom participated in the downstream sale of gas in consumer countries³, the cooperation was extended in 2005: Gazprom's share climbed to 50% minus one share in exchange of Wintershall's acquisition of an upstream licence for production at the giant gas field Yushno Russkoye in Western Siberia (in joint venture cooperation with Gazprom and E.ON). At the same time Wintershall collaborates (24.5%) in the construction of the North-

³ The joint venture has since extended its operations beyond the borders of Germany.

European Gas Pipeline (NEGP) together with Gazprom (51%) and E.ON-Ruhrigas (24.5%). Moreover, E.ON owns 6.5% of the shares of Gazprom.

As set out above, swapped ownership between the companies involved or between subsidiaries run jointly as in the case of Wingas could greatly make involved company interests run the same direction. However, the political landscape in Europe does currently not look too bright for increased consumer-producer ownership swaps. That is due to several reasons: Governments in the European Union seem to be backtracking on issues of liberalisation and market access recently and are proving to be hesitant towards foreign extension into their domestic energy markets. This is in some extent due to undoubtedly quite mixed results of years of (semi-)liberalization that lacked a concomitant privatization. Partially or totally state-owned energy companies – or those with strong ties to governments – in the (Western) EU have been shielded by government policies from liberalization, privatization and take-over, but have been allowed to go fishing in other countries⁴. This has left a *goût amer* concerning liberalization and ownership issues in governments' heads. This is all the more true as the energy sector seems to be one of the most visible bastions of defence of a so-denominated (state) national interest.

At the same time, involvement of a state-owned company raises immediate concerns, reinforced in the case of Gazprom by its vastly intransparent ownership and decision-making structure. Cross-ownership schemes may have a greater chance of success if it was between two privately owned and managed companies. But governments in Europe (East and West) quite understandably raise suspicions that much of Gazprom's decisions are not following company logic or market behaviour, but are strongly congruent with Kremlin political aims.

Moreover, European companies are seen to be just dwarfs compared to Gazprom, for example E.ON-Ruhrigas, Germany's #1 energy company, has a market value equal to just 20% of Gazprom. Swapping ownership with a state-influenced giant would thus extend foreign state policies on the

⁴ See for example the quasi-monopoly on the French market by EDF, which nevertheless has been able and allowed to go shopping in other countries, namely Germany, Spain, the UK, Italy etc.

European market – a situation much feared in Europe. Governments also raise concern that competition and anti-cartel legislation would inhibit such a move, if the merged giant was to possess significant parts of a national market and be vertically integrated – from up-stream to downstream. If this proved to be true, only smaller collaborations would be possible.

Last but not least, the recent past has shown quite frantic reactions of European governments about involvements of foreign companies in their energy sector. The take-over bids of E.ON (Germany) for Endesa (Spain), that of Enel (Italy) for Suez (France) and last but not least that of Cnooc (China) for Unocal (USA) have shown the same nationalistic reaction that the take-over probe of Gazprom on Centrica (UK) had. Consequently, it does barely matter whether the foreign company wishing to swap or gain ownership is inside or outside the EU, nationalistic politics seem to prevail over rationalities of increasing energy supply security. Wittingly (and rightly, one might say), producers complain about Western demands of upstream access to their energy resources – while simultaneously blocking access to their downstream markets.

One interesting issue raised in the debate over ownership transfer out of the UK in the Centrica case is the questionable economic rationale of Gazprom downstream acquisitions. Downstream companies yield a return on investment (ROI) basically comparable to most other industries in Western nations – even in high gas/oil price situations. Conversely, due to current (and forecast) prices, upstream equity gas acquisitions or investments in new fields yield far higher ROIs, due to the fact that the difference between market price and costs generates huge economic rents. Thus, if it were for profit maximisation only, Gazprom would certainly not expand into downstream ventures in Europe, but invest into new production capacity and field acquisitions. Governments thus are concerned that Gazprom's 'West-trail' is motivated mostly by politics.

Conclusions

Whatever the true rationale in the current bids for trans-national ownership may be, it unfortunately shows that the political reality in Europe can certainly not be called ready for swapping ownership with the producer country⁵ in any sizeable proportions. While it would greatly enhance energy security for both consumers and producers, increase energy market transparency, intertwine interests on a geopolitical level, grant technology transfer to the producer and open upstream access to the consumer, it seems that a factual privatization and competition on a level playing field could be seen as a prerequisite. State-run businesses are still tagged with the suspicion of state politics.

From a general perspective, schemes for swapping ownership across producer and consumer countries could be an excellent tool for enhancing energy security, unfortunately though, this tool seems currently to be politically unfeasible. However, the G8 could take up this challenge and reunite in reinforcing its willingness to let market forces prevail over politics. In order to prevent a future of strained international relations due to noticeably increasing re-politization of world energy, the G8 could make a point stressing once more the importance of liberalization and privatization in the energy sector – focussing on the advantages this brings to producers and consumers alike. Crossing ownership between companies is one case in point for a future of deepened integration and cooperation between all parties – increasing the world's energy security.

⁵ neither, for that matter, with any other country.