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A Tale of Two Countries: Italy, Germany, and Russian Gas

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Introduction

Italy and Germany are locked in a struggle over access to Russian gas supplies and the construction of the controversial Nord Stream 2 pipeline. That struggle threatens not only to complicate their bilateral relationship and their respective relationships with Russia, but also to thwart European Union (EU) efforts to consolidate a common approach to energy security and to create a formal energy union. In the wake of the United Kingdom's (U.K.) historic June 23, 2016 ("Brexit") referendum to leave the EU, the negative impact of this dispute on EU energy and trade issues could become heightened. The U.K., with its liberalized energy market, will no longer play a direct role in EU energy policy. Clashes over Nord Stream 2 and relations with Russia could exacerbate the EU's cleavages, exactly at a time when the remaining EU member countries—especially Italy and Germany, which were two of the original six founding countries of the European customs union and single market—need to pull together.

This paper examines the factors that have contributed to the German-Italian dispute over Nord Stream 2, including their respective relations with Russia. It also analyzes their

significance for broader European energy dynamics and geopolitics.

Italy has only recently re-emerged as a major player in the EU after more than a decade of political retreat, and it is exploring both the limits and opportunities of a new leadership role. Italy has been willing to challenge Germany on a number of issues, including the economic austerity measures that Berlin insisted on in response to the Eurozone crisis as a condition for financial assistance to ailing national banks and economies within the countries that adopted the Euro. Italy has also moved to oppose the German private sector-backed decision by a consortium of German companies to finance and construct Nord Stream 2 and has accused the European Commission of adopting double standards in

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not blocking the project. Germany has pushed back on both fronts. Meanwhile Russia, for its part, has tried to find ways to take advantage of the disagreement between Italy and Germany and consolidate its position as the primary natural gas supplier to Europe.

Nord Stream 2: The project

Nord Stream 2 is a project proposed by a consortium of companies led by Russia's gas monopoly, Gazprom, which holds a 50 percent stake in the venture. The other 50 percent is equally divided among Germany's BASF, and E.ON, France's Engie, Austria's OMV, and Royal Dutch Shell. The project would expand and complement the Nord Stream 1 pipeline that is already in operation transporting natural gas from Russia directly to Germany across the Baltic Sea. Like Nord Stream 1, the second pipeline would bypass the longstanding gas transit systems of Ukraine, the Czech Republic, and Slovakia, and pump 55 billion cubic meters (bcm) of Russian gas to Germany.¹ The two main points of contention at the EU level have been the prospect that Nord Stream 2 will increase rather than reduce EU countries' dependence on Russian gas and the loss of

transit revenues for Ukraine at a juncture of acute economic crisis, following Russia's annexation of Crimea in March 2014 and the subsequent war in Ukraine's Donbas region.²

Benefits to the EU energy market

Analysts who question the long-term commercial viability and energy security benefits of Nord Stream 2 usually point out that Europe's gas demand has been depressed since the 2008 economic crisis. However, the core goal of Nord Stream 2 is to replace declining volumes of European domestic fossil fuel production, and to meet new, albeit limited, demand for gas that will be generated by Germany and some other EU member states phasing out nuclear power.³ The majority of EU member states are projected, under most scenarios, to remain dependent on significant imports of Russian gas until at least 2030.⁴ Moreover, absent drastic changes in energy consumption, the European gas supply mix—which includes a significant share of Russian gas—is not expected to change much.⁵

¹ Severin Fisher, "Nord Stream 2: Europe's lack of Trust in its market model," Policy perspectives Vol. 4/4, CSS ETH Zurich, March 2016.

² For further readings on the debate about Nord Stream 2 see Andreas Goldthau: "Assessing Nord Stream 2: regulation, geopolitics & energy security in the EU, Central Eastern Europe & the UK," Strategy Paper 10, Department of War Studies & King's Russia Institute, 2016.

³ Tim Boersma, "Further reduction of Dutch natural gas production: The end of an era?," Brookings Up Front, June 2015, <http://www.brookings.edu/blogs/up-front/posts/2015/06/26-dutch-natural-gas-production-boersma>.

⁴ See Ralf Dickel, Elham Hassanzadeh, James Henderson, Anouk Honoré, Laura El-Katiri, Simon Pirani, Howard Rogers, Jonathan Stern & Katja Yafimava, "Reducing European Dependence on Russian Gas: Distinguishing Natural Gas Security from Geopolitics," OIES Paper 93. Oxford: Oxford Institute for Energy Studies, 2014, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/10/NG-92.pdf>.

⁵ Tim Boersma, Tatiana Mitrova, Geert Greving, Anna Galkina, "The Impact of the Crisis in Ukraine on the European Gas Market," Policy Brief, October 2014, <http://www.brookings.edu/research/papers/2014/10/european-gas-market-import-dependence>.

Nord Stream 2's utility is also questioned in light of the fact that the full capacity of the Nord Stream 1 pipeline has not been fully-utilized, since the consortium has only secured access to 50 percent of the OPAL pipeline that connects Nord Stream 1 to onshore gas transit and distribution networks. This is, however, due to anti-monopoly limitations imposed by the EU's Third Energy Package. In accordance with these provisions, the companies in the Nord Stream 1 consortium are precluded from using the pipeline's full capacity and must make the additional 50 percent available to other gas suppliers.⁶

Compliance with the EU Third Energy Package regulation

The Third Energy Package is a set of directives adopted by the EU in 2009 to integrate national gas markets.⁷ The package represents the toughest hurdle for Gazprom's investments in Europe because it stipulates that gas production and transmission must be managed by two different entities. In addition, third-party access to pipeline networks must be provided to competing gas suppliers. In 2011-2012, Gazprom was granted an exemption from the application of the Third Energy Package for the construction of the Nord

Stream 1 pipeline by the EU Commission. The Commission's legal service has since issued opinions in defense of Nord Stream 2 that suggest EU energy market rules also do not apply in the case of the second pipeline—raising the prospect of another official exemption from the EU Third Energy Package.⁸

Bypassing Ukraine

Since the crisis in Ukraine, many EU member states—not just Italy—have pointed out the political incoherence of building a new pipeline that clearly benefits Russia's energy sector at a time when Russia is subject to EU and other international sanctions after the annexation of Crimea. The EU has also expressed economic as well as political support for Ukraine given that the proximate cause of the crisis and ensuing war in Donbas was Ukrainian and EU efforts in 2013 to conclude an association agreement and a deep and comprehensive trade agreement (DCFTA). The construction of Nord Stream 2 would create a permanent alternative gas export route from Russia to Europe that would eclipse the existing pipeline network across Ukraine. As a result, Kiev would lose over \$2 billion annually in transit revenues.⁹ After the construction of Nord Stream 1, Poland had a similar experience in 2014.¹⁰ Ukraine would also

⁶ Vladimir Socor, "Gazprom Required to De-Monopolize Access to German OPAL and NEL Pipelines," *Eurasia Daily Monitor*, Volume 9, Issue 56, March 2012.

⁷ The EU energy liberalization agenda started in 2009. For more background see Tim Boersma "Energy Security and Natural Gas Markets in Europe Lessons from the EU and the United States," Routledge 2015.

<https://www.routledge.com/Energy-Security-and-Natural-Gas-Markets-in-Europe-Lessons-from-the-EU/Boersma/p/book/9781138795129>.

⁸ This is a major gray area, and lawyers will have to figure out whether or not the consortium will be exempted. For

other major pipeline projects, including Nord Stream 1 and TAP, exemptions have been granted. That also raises questions on how these cases compare to Nord Stream 2 and about the effectiveness of the EU law—in the sense that it should not be influenced by politics. For more details in this issue, see Sijbren De Jong, "Why Europe should fight Nord Stream II," *EUobserver*, February 2016 http://europa.eu/rapid/press-release_IP-14-585_en.htm.

⁹ Interfax Ukraine

<http://en.interfax.com.ua/news/economic/289356.html>.

¹⁰ Strzelecki M., Martewicz M., "Gazprom Limits Polish Gas Supplies as Reverse Flows Halt," *Bloomberg*,

likely find itself cut off from Russian gas supplies for its own domestic consumption. Even if destination clauses that prevent the buyer from reselling the natural gas were dropped, Gazprom would not export enough gas to allow European countries like Germany to resell excess domestic supply to Ukraine.¹¹

Since 2006, Ukrainian-Russian disputes over gas prices have been the source of major gas supply disruptions in Europe. Prior to the construction of Nord Stream 1, most of Russian gas to Europe had been exported through Cold War-era pipeline networks across Ukraine and Poland. Ukraine used the same pipelines both for domestic gas distribution and for gas transit to Europe. Consequently, when Russia cut gas supplies to Ukraine in 2006, 2009, and 2014, it cut off supplies for Europe as well. For this reason, Russia has long tried to find alternative ways to reach the EU energy market—with the goal of completely cutting off Ukraine in 2019, when its current gas purchase contract with Gazprom expires. In December 2014, Gazprom's CEO stated unequivocally that the role of Ukraine as a

transit country for Russian gas *will be reduced to zero.*¹²

Security reasons

Beyond Ukraine, eight EU member states, all Central or Eastern European countries, signed a petition against Nord Stream 2 citing security concerns. The Czech Republic, Hungary, Poland, the Slovak Republic, Romania, Estonia, Latvia, Lithuania, and Croatia are the European countries most dependent on Russian natural gas. The signatories pointed out that Nord Stream 2 poses “risks for energy security in the region of Central and Eastern Europe, which is still highly dependent on a single source of energy.”¹³ In the view of some energy analysts, after the construction of Nord Stream 2, Russia could cut off gas supplies to these countries without affecting access to its main Western European market. The countries, could therefore all be simultaneously exposed to a loss in transit revenues and a shortage in gas supplies.¹⁴

September 2014

<http://www.bloomberg.com/news/articles/2014-09-10/poland-says-gazprom-cut-gas-supplies-via-belarus-ukraine>.

¹¹ PGNiG (Polskie Górnictwo Naftowe i Gazownictwo SA), Poland's main gas importer, was forced to use its traders in the German market to purchase the missing gas volumes. Such situations create market volatility and show that Gazprom treats clients in the CEE and Western Europe differently. See

http://en.pgnig.pl/documents/18252/359153/Company+Overview_EN+December+2014/b70516b7-6ae9-4c10-85e0-9cdae9a031d9

¹² Karel Beckman, “Gazprom CEO Alexei Miller: This is the beginning of the end of Gazprom's business model in Europe,” December 2014, www.energypost.eu.

¹³ Alan Riley, “Nord Stream 2: Too Many Obstacles, Legal, Economic, and Political to be Delivered?,” Issue Brief, Atlantic Council, November 2015

<http://www.atlanticcouncil.org/publications/issue-briefs/nordstream-2-too-many-obstacles-legal-economic-and-political-to-be-delivered>.

¹⁴ A counter argument could be that since destination clauses are prohibited, CEE countries would be granted reverse flows. Last year, over 32 bcm of gas was re-exported from Germany, partly to the CEE. See <http://www.naturalgaseurope.com/german-exports-topped-30-bcm-in-2015-28791>, However, as I explain later, it could also happen that Gazprom would not pump enough gas volume to allow Germany to re-sell it.

Italy, Germany, and Russia: Different perspectives

Italy has very different concerns about Nord Stream 2, which are all closely related to the new role Italy wants to play within the European Union. After the controversial tenure of Silvio Berlusconi as prime minister, it was hard for Italy to rebuild international credibility and trust. In the EU, Italy was blamed, especially by Germany, for not respecting the parameters of the Maastricht Treaty and the Fiscal Compact. After four years of difficult reforms aimed at recovering from the economic crisis and preventing further damage, Italy wants to rehabilitate its foreign policy image. Since Prime Minister Matteo Renzi came to power, there have been three leitmotifs in the Italian approach towards the EU: 1) challenging austerity in economic policy; 2) appealing to the EU for assistance in managing the refugee crisis in the Mediterranean; and 3) seeking a leading role in European foreign policy.

In contrast to Italy, Germany has long occupied a dominant position in the EU as the strongest European economy. After the 2014 European parliamentary elections and the creation of a new Commission, Germans hold key positions in every institution of the EU. Among others, Uwe Corsepius is the General Secretary of the European Council, Klaus Welle is the Secretary General of the European Parliament, Martin Schulz is the president of the European Parliament, and Klaus Regling is the director of the European Stability Mechanism. Germany has always acted in total compliance with EU treaties, but it has also made clear that the EU cannot make a decision without Germany's approval. This has created frictions within Germany and degrees of resentment toward the EU, especially when

other countries are seen to take shortcuts or to avoid compliance. The success of the euro-skeptic Alternative for Germany (AfD) Party in recent local elections underscores the current pressures facing German Chancellor Angela Merkel in maintaining Germany's governing coalition, especially against the backdrop of the European refugee crisis.

Italy's aspirations to play a bigger role in Europe have put it in political rivalry with Germany. In 2014, Prime Minister Renzi pushed for stronger Italian representation in the EU in order to counterbalance what Rome considers to be Germany's over-representation. Renzi, for example, lobbied for Italian Foreign Minister Federica Mogherini to become the EU High Representative for Foreign Affairs and Security Policy, ultimately overcoming the opposition of some EU member states who considered her "pro-Russian."

Relations with Russia and EU energy policy have both become part of this Italian-German rivalry, at a time after Brexit when three of the original six founding members of the EU—France, Germany, and Italy—will play larger roles than before in shaping the future of Europe. A political and economic clash between Italy and Germany over Nord Stream 2 and Russian energy could have broader political ramifications for the EU, especially as France does not have a particular stake in this issue.

Berlin has traditionally adopted an accommodating political approach towards Moscow, but the Russian-German relationship has become more challenging. Despite significant commercial ties, the German government has adopted a very tough approach towards Russia since the beginning

of the Ukraine crisis in late 2013. German Chancellor Merkel has been one of the staunchest advocates of EU sanctions. Russia has retaliated by trying to exploit the divisions within German society toward the EU, including by financing euro-skeptic parties like the National Democratic Party and Pegida Movement.¹⁵ In addition, Russia has promoted and encouraged a pan-European anti-fracking campaign aimed at preventing Germany (and other countries) from diversifying domestic energy sources and producing non-conventional gas and oil. Given the war in Ukraine's Donbas region and the overall crisis in Russian-Ukrainian relations, completing Nord Stream 2 is a top priority for Moscow and Gazprom to secure its export routes to the European market, and head off the prospect of EU member states turning to LNG instead of pipeline gas from Russia.

South Stream as political leverage

In addition to Nord Steams 1 and 2 across the Baltic Sea, Russia has also pursued the development of a new gas export pipeline across the Black Sea—South Stream, which is part of a “pincers strategy” of pipeline networks aimed at binding Europe northwards and southwards to Gazprom and other Russian producers. Italy has been heavily involved in the development of the South Stream project, which is one factor in its opposition to Nord Stream 2.

¹⁵ Tony Paterson, “Putin’s far-right ambition: Think-tank reveals how Russian President is wooing – and funding – populist parties across Europe to gain influence in the EU,” *The Independent*, November 2014, <http://www.independent.co.uk/news/world/europe/putin-s-far-right-ambition-think-tank-reveals-how-russian-president-is-wooing-and-funding-populist-9883052.html>.

The South Stream pipeline was an initiative led by Gazprom designed to connect Russia with Bulgaria across the Black Sea, bypassing Ukraine like Nord Stream, but also bypassing Turkey, where Russia constructed an earlier undersea gas pipeline, Blue Stream. Moscow's and Gazprom's goals since the early 2000s have been to ensure multiple direct pipeline routes to Europe to mitigate the transit risks to Russian interests and to maximize Russia's export options and leverage. The Italian firm ENI held a 20 percent share in the South Stream venture, while its subsidiary SAIPEM secured a \$3 billion contract to build the undersea section.¹⁶ The EU Commission expressed vocal opposition to the construction of this particular pipeline and, in contrast to Nord Stream 1, found South Stream non-compliant with the EU Third Energy Package.

Many energy experts consider South Stream a geopolitical rather than an economic project for Russia. The fact that Bulgaria was selected as the first EU country to receive gas from South Stream was viewed as telling. Bulgaria is a peripheral country for the European energy market and not a natural hub for gas redistribution. It is also a traditional Soviet-era bridgehead in Europe. Bulgaria and Russia have established strong business connections since the collapse of the USSR, with significant Russian investments in the Bulgarian energy and utilities sectors. South Stream would require new connecting pipelines across the Balkans and Adriatic to Italy and onward to

Also see Mathew McDonald, “Putin and Pegida,” *The American Interest*, January 2015 <http://www.the-american-interest.com/2015/01/13/putin-and-pegida/>.

¹⁶ Emanuele Scimia, “South Stream’s Demise Shakes up Italian-Russian Relations,” December 2014 <http://oilprice.com/Energy/Natural-Gas/South-Streams-Demise-Shakes-up-Italian-Russian-Relations.html>,

other EU markets that would also be in competition with new pipeline networks from Azerbaijan and Turkey favored by the EU, including the Southern Gas Corridor and TAP.¹⁷

Under EU pressure, the South Stream project was ultimately suspended in 2014 to loud Italian complaints about the economic losses for its energy industry. The details of the deal and the structure of ENI's participation in South Stream reveal a more complex story. Italy's energy giant, ENI, is a unique European company that, like Russia's Gazprom, deals with all stages of the oil and gas business—upstream, midstream, and downstream—and handles all operations from extraction to distribution through its own infrastructure. In the case of South Stream, ENI was not responsible for gas extraction, so the profitability of the project would have been more limited than in other ENI ventures in the Middle East and North Africa. In addition, when the project was suspended in 2014, ENI had not spent much money, while Gazprom eventually decided to pay \$1 billion in compensation to the consortium to cover their stakes.¹⁸

There was, in fact, no real loss for ENI—especially as ultimately, once the pipeline was built, the infrastructure construction costs would fall on the end gas consumers. ENI has also retained a broader deal with Gazprom for gas supplies. Absent gas deliveries through South Stream, these exports are brought

through Gazprom's access point in Slovakia.¹⁹ Furthermore, the Italian government's most vocal complaints about economic losses came just as Nord Stream 2 was launched. Rome criticized EU double standards in pushing to suspend South Stream and called on the Commission to deal with Nord Stream 2 in the same way. Between the lines, Rome was clearly demanding that the EU treat Italy and Germany as equal powers with equal rights to have their own signature gas pipeline projects with Russia.

Nord Stream 2's threat to Italy's role as an energy hub

Energy has always been an issue for Italy given its significant dependence on gas and oil imports, and due to a strong environmental bias in its energy policies. The use of nuclear energy was rejected in 1987, and there have been several efforts to prohibit drilling within 12 miles of the Italian coast, including through a referendum in April 2016. Italy is the EU's second largest importer of Russian gas. Natural gas accounts for nearly a half the total value of Italy's imported goods and is mainly used in electricity generation for manufacturing plants.²⁰

To date, most of Italy's gas imports from Russia have come through Ukraine. If Gazprom succeeds in cutting off its exports through Ukraine in 2019, which might be the case if

¹⁷ Interview with Edward Chow, senior fellow in the Energy and National Security Program at CSIS, April 2016.

¹⁸ "Gazprom pays \$1bn for EU partner shares in South Stream," Russia Today, March 2015
<https://www.rt.com/business/245621-gazprom-partners-debt-shares/>.

¹⁹ However, ENI and Gazprom still disagree on the gas price, which is normally linked to the oil price: Gazprom

wants ENI to pay the price established in their agreement eight years ago, while ENI wants the market price. Thus, ENI is likely taking Gazprom into arbitration.

²⁰ Nicolò Sartori, "Rotta di collisione su Nord Stream 2," Affar Internazionali, December 2015
<http://www.affarinternazionali.it/articolo.asp?ID=3263>.

Nord Stream 2 is completed, then all Italian gas imports would transit through Germany. Italy would then pay higher gas prices along with the transit fees as the costs for building the new distribution infrastructure would be amortized through an increase in the consumer price of the gas.

In addition to raising gas prices for Italian consumers, Nord Stream 2 threatens to undercut Italy's role as a EU energy hub in the Mediterranean, and one of the key elements in the proposed framework for the European Energy Union.²¹ Since the suspension of South Stream, the Italian government has focused on supporting the development of the Southern Gas Corridor (SGC). This is a threefold system of pipelines aimed at reducing Europe's dependence on Russian gas: 1) the South Caucasus Pipeline (SCP), bringing Azerbaijani gas from the Caspian Sea to the Georgian-Turkish border; 2) the Trans-Adriatic Pipeline (TAP), now in the initial stages of construction, which will transport gas directly to Italy; and 3) the Trans-Anatolia Natural Gas Pipeline (TANAP), which is under construction and will connect the other two pipelines by 2018. This project is being carried out by the Italian-based engineering company, Nuovo Pignone,

along with the infrastructure group SNAM, and SAIPEM (ENI's subsidy), as well as another Italian oil and gas contractor, MICOPERI.²²

These projects have intensified Italy's cooperation with Azerbaijan, which became the largest oil supplier to the Italian market in 2013 and 2014. In the first eleven months of 2015, Azerbaijan covered 17.9 percent of Italian crude oil requirements.²³ TAP will carry 10 bcm of Azerbaijani offshore gas to Europe by 2020, with the prospect of doubling future supplies through the Ionian Adriatic Pipeline and the Interconnector Greece-Bulgaria. Relations between Moscow and Rome remain strong and Italy's energy partnership with Azerbaijan is not conceived as being anti-Russian. Although Russia's energy exports to Italy have decreased in the last two years due to a fall in demand, Russia nonetheless remains Italy's main supplier of natural gas.²⁴ Moscow has so far given no indication that it sees the Italian energy market as a zero-sum-game field and has expressed any public concern about the SGC as a competitor to South Stream or other energy projects. Azerbaijan cannot match the 147 bcm of gas that Gazprom provided to Europe in 2014; and Gazprom has even stated its willingness to also transit some

²¹ This is a project launched by the Juncker EU Commission aimed at diversifying energy sources and implementing European initiatives on the Southern shore of the Mediterranean. It was developed following the crisis in Ukraine, which endangered EU energy supplies; its five priority actions are: 1) energy security, trust, and solidarity; 2) full integration of the EU energy market; 3) energy efficiency to contain demand; 4) de-carbonization of the economy; and 5) research and innovation. Italy was supposed to be a key transit country for Northern Europe and bolster the energy interconnections between EU member states.

²² Emanuele Scimia, "Southern Gas Corridor's Advance Cool off Energy Cooperation Between Italy and Russia,"

Eurasia Daily Monitor, Volume 12, Issue 145

http://www.jamestown.org/programs/edm/single/?tx_ttnews%5Btt_news%5D=44248&cHash=7a7fb0b186b7a58d38a711a3b2089cc1#.VzngYJPhBsM.

²³ "Importazioni di greggio per paese di provenienza," July 2015 www.unionepetroliera.it.

²⁴ Emanuele Scimia, "For Now, Italy's Relations With Azerbaijan Do Not Upset Russia," Eurasia Daily Monitor, Volume 13, Issue 35, February 2016

http://www.jamestown.org/programs/edm/single/?tx_ttnews%5BbackPid%5D=27&tx_ttnews%5Btt_news%5D=45121#.VznhR5PhDR0.

of its own gas, along with Azerbaijani gas, in the SGC.

Compared to other competing pipeline projects, the construction of Nord Stream 2 is a major threat to Italy's role as energy hub. Transferring the fulcrum of EU energy supply north towards Germany would reduce the benefits of the SGC development, and undercut central Italy's role in redistributing Caspian gas to the rest of the EU market. If Russian gas is exported exclusively through Germany, then the Azerbaijani gas transferred to Italy through TAP will barely fulfill 1 percent of European gas demand. Russian gas currently accounts for more than 20 percent. Germany would become the dominant European and EU gas hub.

Italy's response to Nord Stream 2

Italy is thus less concerned about economic losses to its companies from the suspension of South Stream and more worried about losing its competitive advantage in the European energy sector to Germany. Italy opposes Nord Stream 2 because of the threat this poses to Italy's position as Europe's Mediterranean energy hub. Relations with Russia are also a key element in Italy's reaction to Nord Stream 2. Italy is Russia's fifth-largest foreign trade partner. Russia exports 15 percent of its oil to Italy and 30 percent of its gas, in addition to ferrous and nonferrous metals and timber. On the other hand, Italy delivers manufactured goods, textile fabrics, machinery, chemical products, and consumer durables to Russia. Almost 500 Italian firms have offices in Russia.

²⁵ Beda Romano, "Renzi critica Merkel: non raccontateci che date il sangue per l'Europa," *Il Sole 24ore*, December 2015 <http://www.ilssole24ore.com/art/notizie/2015-12->

Russia is also a key strategic partner for Italy, which has longstanding national interests in Libya. The Libyan crisis, the growing terrorist threat from the Islamic State in Libya, and all the difficulties related to harboring refugees attempting to reach Italy from the Libyan coast have been a major political and economic (as well as security) preoccupation for the Italian government. Libyan instability has severely affected the Italian energy market. Before the current crisis, Italy imported 20 percent of its oil and 10 percent of its natural gas from Libya. The Italian government seeks Russia's support at the United Nations level to help establish and agree on a long-term strategy for dealing with Libya and ensuring its long-term stability. Rome sees close energy relations with Moscow as a key factor in encouraging broader political cooperation.

In the meantime, as in other areas of Italian-Russian relations, Italy has adopted a dual-track strategy in response to Nord Stream 2. On the one hand, Rome complains about the project's non-compliance with the Third Energy Package and denounces the Commission's double standard, insisting that the EU should properly review Nord Stream 2 before the project can proceed. Renzi has also stressed it is inconsistent for the EU to prolong its economic sanctions on Russia and insist on the suspension of South Stream if the Commission simply allows Nord Stream to go ahead.²⁵

At the same time, Italy has also sought bilateral agreements with Russia, including even securing a role for Italian companies in the Nord Stream 2 construction. Russia's Gazprom-owned newspaper, *Kommersant.ru*, for

[18/il-bilancio-premier-2015-italia-segnale-svolta-140737.shtml?uuiid=AClcm2vB](http://www.ilssole24ore.com/art/notizie/2015-12-18/il-bilancio-premier-2015-italia-segnale-svolta-140737.shtml?uuiid=AClcm2vB).

example, reported that SAIPEM is the most likely candidate to acquire the \$4 billion contract for constructing the two underwater branches of North Stream 2 across the Baltic Sea. The scale of the construction is huge—the pipelines would extend 25,000 km with a capacity 55 bcm per year. The Russian newspaper reported that SAIPEM has a good chance of winning the contract because of its previous construction work with Gazprom for North Stream 1. Some Italian experts are skeptical that Italian companies would gain any advantage from joining the Nord Stream 2 consortium.²⁶ ENI's primary revenues come from gas extraction, and as Nord Stream 2 does not offer this option, ENI's profit margin would be low. Only SAIPEM, which focuses on pipeline infrastructure would stand to benefit; and any profits from ENI's participation in Nord Stream 2 would still be eclipsed by the losses related to Italy losing its position as an energy hub to Germany.

Italy has other cards to play with Moscow. In early 2016, Russia's Gazprom, Italy's Edison, and Greece's DEPA signed a Memorandum of Understanding for a project resembling a scaled down version of South Stream.²⁷ Instead of 63 bcm, this project envisages the construction of a pipeline with a capacity of 16 bcm that would run in parallel with the Southern Gas Corridor to Bulgaria. From there the pipeline would be extended to Greece, joining the Interconnector Turkey-Greece-Italy (ITGI), which is still waiting final completion. If realized, this project could bring significant volumes of Russian gas directly to Italy. Like

Nord Stream 2, the pipeline would bypass Ukraine. If the EU Commission allows the construction of Nord Stream 2, Italian analysts believe it would be hard for the Commission to then justify blocking this pipeline project.

Italy and Russia have no significant history of competition or conflict, in spite of Italy's role in World War II. Since the 2000s, Italy has aspired to be “the” European leader in relations with Russia, or at least equal to Germany in making decisions over broader EU relations with Russia. Italy certainly wants to make sure that German interests do not supersede those of Italy and do not interfere with Italy's economic, trade, and security strategies. Thus, Italy always attempts to position itself at the forefront when it comes to the EU's interactions with Russia. Prime Minister Matteo Renzi was the only representative of EU member states to attend the St. Petersburg Economic Forum in June 2016 together with EU President Jean-Claude Juncker. He has also made it clear that he will use Nord Stream and the dispute with Germany as political leverage within the EU if it will advance Italy's interests.

Germany's perspective on Nord Stream 2

Like Italy, Germany sees its energy security as closely linked to Russia—partly because Germany is dismantling its nuclear plants and EU energy production is declining, but also because Germany wants to play a key role in determining European gas prices. In 2013, German imports of Russian gas amounted to 39 percent of Germany's total imports, and

http://www.repubblica.it/economia/finanza/2016/02/24/news/edison-gazprom-depa_accordo_per_il_gasdotto_italia-grecia-134164530/.

²⁶ Interview Nicolò Sartori, Senior Fellow in the Energy Program at the Institute of International Affairs, Rome, Italy, March 2016.

²⁷ “Edison-Gazprom-Depa: accordo per il gasdotto Italia-Grecia,” *La Repubblica*, February 2016

there is no immediate substitute for Russian gas in Germany. A new deal between Gazprom and German gas companies in September 2015 strengthened the already close supply connections.²⁸ The combination of Nord Stream 1 and 2 could increase the total flow of Russian gas to Germany to 110 bcm annually.

German officials have made some reassurances not only to Ukraine but also to Poland and Belarus about the impact of Nord Stream 2 on their interests.²⁹ According to Gernot Eler, the German government's special coordinator for Russian policy, the "additional capacities will result in better energy security in Europe." This is partially true, but how real these reassurances will be over the long term is difficult to say. In 2015, for example, Gazprom reduced its total natural gas flows to Poland specifically to prevent EU member states from then supplying Ukraine via reverse flows through the existing Ukrainian-European pipeline network.³⁰ Gazprom could easily do this again. Also, if gas demand rises again in the EU, there may not be sufficient gas to supply Ukraine as well as other Central European countries would be supplied through Nord Stream 2 gas.

Nord Stream 2 is clearly more than just a commercial project for Germany. Germany's dependence on Russian gas, as well as the German business community's financial and

trade interests in Russia have generated considerable domestic pressure to construct Nord Stream 2. At the same time, the views of the German business community about lifting sanctions on Russia are more diverse. Some business groups like the Ost-Ausschuss would like to see sanctions lifted, but they are the minority. The bulk of German industry and commerce has adopted an almost unanimous position in supporting the government's choices. The chairmen of other two big business associations like the Bundesverband der Deutschen Industrie (BDI) and the Osteuropaverein der Deutschen Wirtschaft have openly stated that they "adhere to the principle of the primacy of politics."³¹

In Germany, the balance of power between politics and economics leans towards the former—state interest takes precedence. Thus, the Nord Stream 2 project is moving ahead not simply because of lobbying by the German business community. German ruling elites also support building the Nord Stream 2 pipeline. Although it can be argued that Nord Stream 2 enjoys multilevel consensus, Germany's attitude towards the project has not always been clear. There are two key factors to consider: Germany's relations with Russia in light of the Ukraine crisis, and disagreements within the German political elite and parties on this issue.

²⁸ Hannes Adomeit, "Germany, EU and Russia: The conflict over Nord Stream 2," Policy Brief series Centre for European Studies/EU Centre of Excellence of Carleton University Ottawa.

²⁹ "Germany seeks to overcome opposition to Nord Stream 2," February 2016
<http://www.euractiv.com/section/energy/news/germany-seeks-to-overcome-opposition-to-nord-stream-2/>.

³⁰ Marek Strzelecki, Maciej Martewicz, "Gazprom Limits Polish Gas Supplies as Reverse Flows Halt," Bloomberg September 2014

<http://www.bloomberg.com/news/articles/2014-09-10/poland-says-gazprom-cut-gas-supplies-via-belarus-ukraine>.

³¹ Hannes Adomeit, "Germany's Russia Policy: From Sanctions to Nord Stream 2?" Transatlantic Academy 2015-16 Paper Series, No.3 March 2016.

Germany's Ambivalence on Russia and Nord Stream 2

Russia is a very sensitive issue in German society. There are two main groups: 1) the supporters of *ostpolitik* who wish to engage Russia cooperatively and whose pro-Russian sentiment is also tinged with anti-Americanism; and 2) those who grew up in Eastern Germany, like Chancellor Merkel, who are more critical of the Russian political system and its poor human rights record. There are around 4 million Russian speakers in Germany, divided among ethnic Russians, Russian descendants from German migrants to the Russian and Soviet empires, and Russian Jews.³²

During the Ukraine crisis, Chancellor Merkel acted as the leading stateswoman of the EU. She adopted a strong position on sanctions and urged reluctant countries like Italy and smaller eastern European countries with close relations with Russia, like Slovakia, the Czech Republic, Hungary, and Cyprus, to support them. At the same time, Merkel never closed the door to dialogue and always bore German national interests in mind. Chancellor Merkel has talked to Putin more frequently than any other world leader. She made 35 phone calls in the first eight months of 2015, for example. Germany has more trade with Russia than any other European state. Germany's eastward-oriented business sector is a powerful lobby, including specifically within Merkel's own Christian Democratic Union (CDU). In March 2014, at the peak of the Crimea crisis, Merkel

met with the four largest German business associations in Munich for high-level talks about trade between Russia and Germany and the implications of the crisis.

Despite her assertive attitude towards the Russian Federation, Merkel has seemed to support the Nord Stream 2 project. In December 2015, she stated: "I made clear, along with others, that this is a commercial project; there are private investors."³³ However, her defense of Nord Stream 2 is closely linked to other trends in Germany's political landscape. Germany's Vice Chancellor and Economic Minister, Sigmar Gabriel, is one of the main supporters of the Nord Stream 2 deal. He personally travelled to Russia to conclude the deal with Putin in the Kremlin. Gabriel has asserted that Brussels and the EU should have limited involvement with the project.³⁴ He has also presented both Germany's leverage in the EU and the Nord Stream 2 as a means of improving relations between Germany and Russia to address the Syria crisis, which has sent millions of refugees into Europe and Germany.

The Bavarian "sister party" of the CDU, the Christian Social Union (CSU) is particularly critical of the EU sanctions against Russia, which it sees as an obstacle to securing Moscow's assistance in resolving the civil war in Syria. The CSU has openly criticized Merkel's choices related to the refugee crisis and has stressed that cooperation with Russia is an important way of also coping with this issue.

³² Interview with Angela Stent, Senior Fellow at the Transatlantic Academy and the German Marshall Fund, April 2016.

³³ "Merkel defends Nord Stream-2 pipeline," Russia Today, December 2015 <https://www.rt.com/business/326440-merkel-gas-nord-stream2/>.

³⁴ Albrecht Meier, "Putin and Gabriel team up on Nord Stream 2 against Brussels," November 2015 <http://www.euractiv.com/section/energy/news/putin-and-gabriel-team-up-on-nord-stream-2-against-brussels/>.

Similarly, the German Foreign Minister Frank-Walter Steinmeier, who is the leader of the German Social Democratic Party (SPD) seems to support dialogue and compromise with Russia, in spite of his open skepticism that lifting sanctions will result in a constructive Russian role in Syria. Steinmeier insists that implementing the German and French-backed Minsk II plan for the war in Ukraine is indispensable for achieving a rapprochement with Moscow. The current EU sanctions are closely linked to the implementation of Minsk II.

Despite the explicit support of the Green Party, which opposes accommodation with Russia, Chancellor Merkel clearly cannot just ignore the stances of other prominent German politicians, who are instrumental in her coalition government. She needs to signal flexibility towards Russia on Nord Stream 2, even though she has acknowledged the potential damage Nord Stream 2 could do to European energy independence and to the credibility of European foreign policy. From a market perspective, a national government pressuring its companies to dump a pipeline project would seem very outdated and anti-free market.³⁵ According to some analysts, Chancellor Merkel may be encouraging the EU Commission behind the scenes to review the Nord Stream 2 project for its non-compliance with the EU Third Energy Package. If the Commission does not grant Nord Stream 2 the same exemption as Nord Stream 1, Merkel could avoid all of the negative consequences of having to intervene herself, and could present the decision as a more coherent choice for the EU in general.

³⁵ Severin Fisher, "Nord Stream 2: Europe's lack of Trust in its market model," Policy perspectives Vol. 4/4 March 2016., CSS ETH Zurich.

Conclusion

This analysis has examined Italian and German perspectives on energy security, relations with Russia and EU foreign policy, through the lens of Nord Stream 2. For Italy, Nord Stream 2 threatens its role as an energy hub in the Mediterranean and its competitive position vis-à-vis Germany within the European Union. Nord Stream 2 means an Italian loss in political terms to Germany, including accepting the reality of an EU double standard when it comes to endorsing large German energy projects. Rome has adopted a dual-track strategy in response to Nord Stream 2, challenging the EU to rule against the project, and seeking to engage Moscow directly and bilaterally. For Germany, Nord Stream 2 is a matter of securing economic advantage. It allows Germany a greater role in determining European gas prices and reduces transit risks from the Ukraine crisis. Germany's political ambivalence toward this project is related to the complexity of its coalition politics and the need for the Chancellor to balance different interests within the government and in German society, including in the business community. Italy and Germany have a shared interest in maintaining good relations—or at least economic cooperation—with Russia at both the national and European level. So far, they are pursuing selective cooperation in the critical energy market.

Russia has ample opportunity to take advantage of the Italian-German disagreements over Nord Stream 2 in order to gain leverage in EU foreign policy and ultimately discourage Europe from diversifying

its energy supplies and seeking other sources of gas, including LNG. Against the backdrop of the crisis in Ukraine and the imposition of EU sanctions, as well as the recent decision by the UK to leave the EU, the clash between Italy and Germany could complicate the EU's ability to forge a common strategy for managing the relationship with Russia. The dispute over Nord Stream 2 has already complicated the ongoing EU efforts to create an energy union, by undermining the Commission's role in setting the frame for energy policy and being seen to act as an impartial arbiter.

To resolve this problem, the EU will either have to devise a legal framework that ensures clarity and predictability for reviewing and approving projects like Nord Stream 2, or formulate a more coherent political strategy within the Commission to cope with this issue. Given all the current risks to the European project, the EU, together with Italy and Germany, needs to find ways to resolve this dispute and to reach a common perspective on Nord Stream 2 that reduces the sense of political competition and contention. Without a clear energy strategy and a clear approach towards Russia, Europe's ambiguity in managing high profile projects like Nord Stream 2 will undermine the coherence of the EU foreign policy.

List of Acronyms

ADF	Alternative für Deutschland	<i>Alternative for Germany</i>
BDI	Bundesverband der Deutschen Industrie	<i>Federal Association of German Industry</i>
CDU	Christian Democratic Union of Germany	
CEE	Central and Eastern Europe	
CEO	Chief Executive Officer	
CSU	Christian Social Union in Bavaria	
EU	European Union	
ITGI	Interconnector Turkey-Greece-Italy	
LNG	Liquefied Natural Gas	
Med-REG	Mediterranean Energy Regulators	
Med-TSO	Mediterranean Transmission System Operators	
OPAL	Ostsee-Pipeline-Anbindungsleitung	<i>Baltic Sea Pipeline</i>
SCP	South Caucasus Pipeline	
SGC	Southern Gas Corridor	
TANAP	Trans-Anatolian Pipeline	
TAP	Trans Adriatic Pipeline	

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