

A difficult detachment – Hungarian energy policy with Russia after 2014

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Introduction

While Hungary's policy towards Russia has often been interpreted in an ideological, transformative or opportunistic context, PM Viktor Orbán's Eastern opening fitted relatively well into the foreign policy set of the early-2010s. Hungarian diplomacy turned very forcefully towards foreign economic issues, highlighting its utilitarian and downsizing the value-based characteristics. The economic dimension has prevailed at the expense of conventional diplomatic considerations. The Hungarian Foreign Ministry was renamed Ministry of Foreign Affairs and Trade, where in the Hungarian version „Trade” stands before „Affairs”. Not surprisingly, the Western reception of Hungary's good relations with Russia do not represent a matter of major concern in Budapest, as long as these ties are compatible with the general foreign policy line of the country. Hungarian foreign policy and its Russian nexus has been formed on a „Hungary first” basis, where national interest is defined on a narrowly utilitarian logic.

In the early 2010s Russia seemed to be a desirable partner for economic cooperation. Until 2013 it represented the biggest non-EU trading partner and export destination for Hungary. Expectations were high regarding energy cooperation, Russia was perceived as a huge potential market for Hungarian exports, investments and potentially even other political or foreign policy benefits were expected to come if political relations enhance bilateral rapprochement. For PM Viktor Orbán, a staunch critic of Russia in opposition, it took three years after 2010 to come round and efface his past hostility. The new era symbolically started in January 2014, when Hungary agreed to launch the construction of two new nuclear blocs (Paks2) and contracted the project with Rosatom for 12.5 bln EUR. While the speed and suddenness of this turn was shocking for many Hungarians, the step itself fitted well into the emerging set of Hungarian foreign policy and economic priorities.

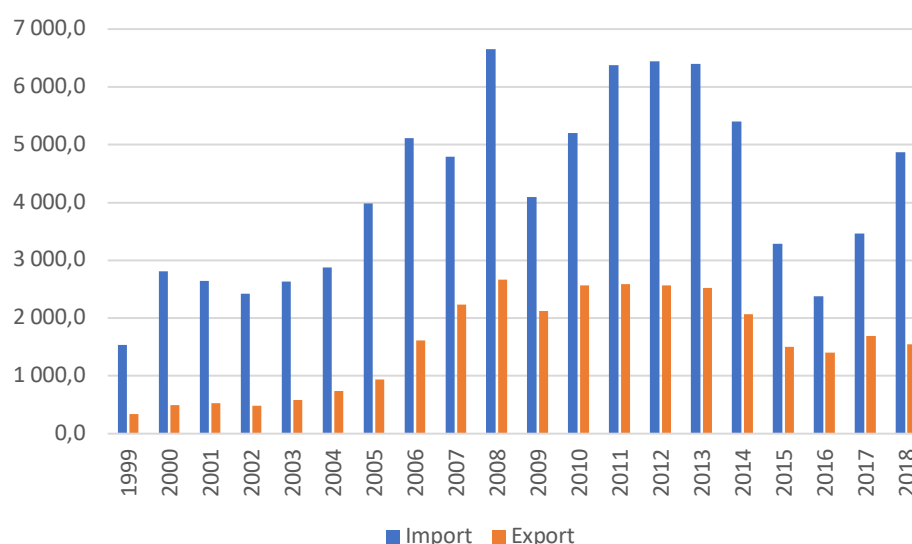


Figure 1. Hungarian-Russian foreign trade, mln EUR, 1999-2018

Source: Eurostat

Bad timing is a recurrent feature of Hungary's Russia policy. By the time of PM Viktor Orbán's visit to Moscow the Euromaidan against Victor Yanukovich was already in full swing. In just a couple of months Yanukovich fell, Russia invaded and annexed Crimea, provoked a bloody conflict in Eastern Ukraine and the Western community imposed sanctions on Russia and its subjects. Prospects for an export offensive was washed away by the incoming Russian recession and collapsing imports, the political and foreign policy costs of nurturing good relations with Moscow have increased dramatically overnight. Viktor Orbán's grand opening became skewed. Having a good deal of irreversibility because of the Paks2 nuclear deal, he could not easily and potentially he did not want to retreat in his Russia policy. Perhaps Budapest even envisaged the new situation as a chance to struck better terms and get preferential treatment due to its tenacity. At the same time the short-term benefits were definitely gone and all what could be expected realistically, was some sort of Western-Russian settlement in the longer run or receiving some sort of reward from Moscow for Hungarian loyalty.

In early 2019 none of these developments are to be seen. The end of the sanction policy does not seem to be closer than four years ago, Russia's economy has been niggling, while instead of compensating Budapest for its loyalty, Moscow seems to be pushing for even more. Thus Hungary had to change to a more rationalistic approach and cautiously ease its ties with Russia, cooling down bilateral relations, even if without damaging its fundamentals. The expected results have not been delivered even according to Fidesz' utilitarian factors of success, on a „Hungary first” basis. The low-hanging fruits have already been collected and there is nothing attractive what Russia may offer at the moment. At the same time there is not too much reason to publicly give up Russian cooperation, retreat from past commitments or even to launch a conflict again. Consequently, Hungary has been distancing itself from Russia in energy related matters in small steps, changed to a “wait and see” behavior and awaits new, positive impulses. Nonetheless, this detachment from Moscow remains highly difficult regarding the Paks2 nuclear issue and despite obvious progress, still hides a number of challenges in the gas sphere.

From internal transformation to geopolitics – cooperation in the energy sector

The new reality in the Hungarian energy sector

Since the mid-1990s, when the Socialist-liberal coalition privatized large chunks of the energy industry and the utilities, multinational companies have been representing the system-building entities in the whole branch. Fidesz had consistently criticized the privatization and aimed to reestablish stricter state control over the sector. After 2010 PM Viktor Orbán marked out four sectors (banking, media, energy and retail), where he expected the domestic capital to take over the dominant positions from foreign ownership. Consequently the government gradually introduced a restrictive system of price and other controls, decreasing sectoral profitability. Simultaneously it expressed its wish to buy out the strategic parts of the branch from foreign multinationals. Except some tensions, the European Commission accepted the new regime, and only a few investigations were launched.

Russia did not and does not have considerable assets in the Hungarian energy industry. While in the 1990s Gazprom established a small foothold based on bilateral gas trade, this became largely insignificant by the late 2000s. The most notable case was the purchase of 21.2% of MOL (Hungarian oil and gas company) from OMV by Surgutneftegas in 2009. Nonetheless, this “adventure” was closed in 2011, when the Hungarian government bought these shares at a large premium. Thus Russia was directly not involved in Fidesz' renationalization campaign. Energy relations to a large extent remained outside the bilateral political relations, since these were governed by private companies on the Hungarian side. Nevertheless, after 2013 energy came back as the central topic of Hungarian-Russian negotiations, enhanced by a massive state-ownership thorough the industry.

While the years between 2010 and 2015 can be described as a transition from foreign-owned to renationalized energy systems in Hungary, after 2015 the sectoral landscape became relatively quiet.

By this time the majority of assets and exclusively all strategic companies were in state or domestic private ownership. The sector was strictly regulated especially as far as residential utility tariffs and ownership relations regarded. In a number of selected issues decision making was transferred to the Prime Minister's Office. These include the Paks2 project entirely, which was separated from the existing nuclear industry, even from issues connected to the functioning Paks1 nuclear blocs. Questions related to natural gas imports and the long-term supply contract (LTSC), its renegotiation and the Russian pipeline projects were also delegated to the political level. Both PM Viktor Orbán and especially foreign minister Péter Szijjártó actively discussed gas related matters with Gazprom and senior Russian officials. External gas policy dossiers were moved from ministries, responsible for energy industry to foreign ministry.

Company	Focus	Organizational model	Organizational changes	Mergers and other transactions	Strategy
E.ON	Electricity and gas	Strategic holding	Universal service in lagally separate unit from January 2014. Declaration of termination the gas universal services April 2015.	Selling of gas-wholesale and storage units to the Hungarian state in 2013. Selling gas USP unit to ENKSZ/FŐGÁZ.	Focus on free market trading and network services. "wait and see" strategy in electricity USP segment, financial optimization.
RWE	Electricity (and gas)	Operative holding (ELMŰ és ÉMÁSZ)	Free-market trading unit legally separated and owned by ELMŰ and ÉMÁSZ	Selling of FŐGÁZ minority stake in 2014 to a state owned bank. Selling of Mátrai Power Plant in 2017.	Similar to E.ON, some structural questionmarks. Selective development of electricity free market segment with concentrating on some innovative activities.
EDF	Electricity	Operative holding	Selling of EDF-DÉMÁSZ holding company to the state owned NKM Zrt in 2017.	Selling of Budapesti Power Plant (BERT) to EPH (2015) As a part of the holding, electricity DSO also sold to NKM (2017)	Leaving the HU market
GDF-SUEZ	Gas (and electricity)	Mixed governing structure (two separate mother)	Selling of free-market electricity (2014) and gas(2015)positions to MET. Declaration of termination the gas universal services April 2015.	Selling of Dunamenti Power Plant to MET (2014)	Leaving the HU market
ENI	Gas	Operative holding	Selling gas USP unit to ENKSZ/FŐGÁZ in 2016.	Selling TIGÁZ Zrt including the gas DSO nad the free marejt trading to MET.	Depletion of assets, leaving the market.

Figure 2. Foreign multinationals adaptation strategies and state buy-outs between 2010-2015

Source: Balázs Felsmann: "Corporate performance under institutional constraints", Summary of Thesis²⁶⁹

The new division of labor emblematically demonstrated both a veer away of the government's attention from energy and a growing differentiation between its internal and external aspects. Given the change-over within the industry and its consolidation, energy policy required a less transformative approach and related decision making became a part of the daily routine. While the cabinet and especially the prime minister preserved their captivity regarding energy, their adherence became more geopolitical and outward. Practically this resulted in the separation of two major "assembly lines" within the sectoral decision making. Gas and nuclear issues, bearing more political and geopolitical content, were delegated to the Chancellery and Foreign Ministry. In other, primarily electricity-related issues, renewables and climate-matters, the responsible ministries could preserve much of their leverage and elaborate more policy-specific initiatives.

²⁶⁹ http://phd.lib.uni-corvinus.hu/1009/13/Felsmann_Balazs_ten.pdf (18 March 2019).

It is important to underline that these later issues have been emerging as the main challenges for energy policy and security in particular. While gas policy issues are perceived as more or less regulated or manageable within the given ramifications, EU climate policies, energy transition and the region's growing power generation scarcity puts electricity security into the spotlight. A critical decision will have to be made in the first half of the 2020s not only in Hungary, but also in a number of regional capitals. This trend diminishes the role of Russia in energy policy. Electricity imports come from the CEE region or Germany, renewable segments are totally independent from the Russia factor, regulation mainly comes from the European environment. It is very telling that the share of natural gas in Hungarian electricity generation fell from 38.3% to 14.5% between 2008 and 2014 (climbing back to 19.4% by 2017). Simultaneously the share of electricity imports increased from 9.5% in 2008 to 28.3% in 2017²⁷⁰. This represents a major switch from Russian gas imports for power generation purposes to direct electricity imports from the EU.

Currently optionality is given and imported electricity seem to be cheaper than gas imports for domestic generation. At the same time, it is highly questionable how long this situation can be sustained, whether the necessary investments will be made to maintain adequate power generation capacity in Europe. Nuclear fleets in France, Germany and CEE countries are about to be decommissioned due to political reasons or their end of their respective life-time. A growing number of national capitals declare their willingness to stop coal power generation in the foreseeable future due to climate considerations. All these trends create major uncertainty about the availability of cheap electricity on the EU markets in the years to come. In the Hungarian case the perceived emerging scarcity on the EU markets was a major reference point of the nuclear lobby in favor of the Paks2 project, despite its anticipated high construction cost.

The new settings of energy decision making, especially as far as its external aspects regarded, are much less transparent than previously. This was partly due to the steep decrease in the number of actors involved. There is no necessity to include companies, definitely not private or foreign owned corporations into the negotiations. Most of the discussions happen on a government-to-government basis, sometimes only with the minimal inclusion of state-owned companies. In the case of Paks2 project, even this later actor was excluded, the Prime Minister's Office directly coordinates it without any corporate representation. In the gas field, since October 2013²⁷¹ negotiations regarding LTSC are conducted (besides the senior political level) between the respective two national champions, MVM and Gazprom. Gas pipeline matters require the inclusion of the gas TSO, FGSZ, owned partly by the state, partly by domestic private owners through its mother company, MOL. Gas wholesale trade has also been consolidated and the market was divided between two major companies. MET Hungary, a subsidiary of Swiss-based MET Holding AG supplies predominantly the industry and the competitive sectors, while MVMP, owned by MVM, serves the residential and public demand. Given its past ownership patterns and activity record, the MET Group, a medium-size energy trader within Europe, allegedly belongs to senior Hungarian private persons and decision makers. In this landscape PM Viktor Orbán can control any processes within the industry.

MET International AG has become an important entity in another respect. While the holding was established as late as in 2010 in order to consolidate the MET Group's gas purchases, its activity very rapidly went beyond the national and regional magnitude. Currently it works in 28 countries with 6.1 bln EUR revenue. In 2017 it traded more than 35 bcm natural gas, started to invest intensively into gas and solar power generation assets. Simultaneously, the ownership structure has changed. The former Russian (Ilya Trubnikov) and Russia-related owners (Normestone), as well as those related to Viktor Orbán (István Garancsi, György Nagy) sold their shares to the management, first of all to CEO Benjámín Lakatos. Formally a major bank credit made it possible for the young CEO to buy the majority of the

²⁷⁰ „Data of the Hungarian Electricity System”, 2009 and 2017 yearbooks, Available at: <https://www.mavir.hu/web/mavir/a-magyar-villamosenergia-rendszer-statisztikai-adatai> (18 February 2019).

²⁷¹ In October 2013 the E.ON purchased the gas wholesaler, holding the Russian LTSC and the storage to state-owned MVM.

company. Nonetheless, the company seems to have close relations with the current government and behaves like a national champion in Hungary related matters. It became a stakeholder in the Romanian Black-sea gas issue by allocating pipeline capacities along the route and also a shipper in the „South Stream lite” Bulgarian section. All this suggests that, while MET tries to distance its public image from the Hungarian government regarding its ownership matters, it still collects the benefits of Hungarian gas diplomacy.

In the following pages three issues, analyzed in the previous edition of this report, will be reassessed. These are the Paks2 project, the evolving story of the new long-term gas supply contract (LTSC) with Gazprom and the highly relevant Romanian gas transit matter, and at last the issue of South Stream lite, stretching from Turkey to Hungary. The signs of a more cautious Hungarian approach, the end of high expectations from the Russian nexus are visible in all these cases. Nonetheless, Russia still can offer positive outcomes in the field of gas policy, thus Hungarian-Russian relations preserved much of their cooperative attitude. The changing logic of the relations is more visible in the nuclear field, where tensions are at hand, delays and some problems are publicly admitted. The gap between the respective motivations has widened in the last two years and Moscow may put an increasing pressure on Budapest in the years to come.

The Paks2 project

The Paks2 credit and construction contracts were signed in 2014-15 and envisaged the building of two 1200 MW blocs by 2025-27 for 12.5 billion EUR. The Russian side also offered an industrial credit-line worth 10 billion EUR until 2025 at a fix, tiered interest rate between 3.9-4.9% and a 40% localization rate within Hungary. The characteristics of the deal are similar to other construction projects of Rosatom in Belarus, Finland or Vietnam. The deal was prepared in total secrecy on the political level in the second half of 2013, announced at PM Viktor Orbán’s visit in Moscow in January 2014. The government described the project as the „deal of the century”²⁷², referring especially to the credit-line agreement, which was described as highly attractive both in terms of size and interest rates. Preparations for the expansion of the nuclear plant were already ongoing during the socialist government, but at that time, foreseeing an international tender for the project. The swift and non-transparent decision brought great criticism for the project from many actors, who warned that it is a hotbed for corruption. Many saw this fear justified when PM Orbán’s former ally Lajos Simicska described in an interview for the news portal 24.hu how they prepared the takeover of the top commercial TV station RTL Klub. According to Simicska, Orbán asked him about a possible price. “I told him I do not know but at first glance probably around 300 million Euro, 100 billion Forint, to which [Orbán] replied, ‘That’s no problem, Rosatom will buy it for me’.”²⁷³ Furthermore the fact that companies of Mr Simicska won procurements (future references) for works connected to the operating of the Paks power plant in 2013 supported the view that Paks2 will probably be an enormous opportunity to channel public funds into the pockets of government-close oligarchs.

The first couple of years were relatively silent in terms of project management. The contracts had to be approved by various EU bodies and from a number of different aspects. The European Commission investigated the project in three regards. The government refused to give the project to a separate corporate entity and kept it directly within the state administration, financing it from tax-payers money. This was an obvious case of state-aid, thus its effects on the market relations had to be assessed. The government argued that under the contractual conditions the project is profitable and would be desirable on a normal, private company basis. In its March 2017 decision, DG Competition

²⁷² Among others: „A paksi bővítés az évszázad üzlete”, 17 February 2016, Available at: <http://www.miniszterelnok.hu/a-paksi-bovites-az-evszazad-uzlete/> (20 February 2019).

²⁷³ Benjamin Novak: Simicska: Orbán planned to buy out independent TV station with Russian money. 4 April 2017, Budapest Beacon. Available: <https://budapestbeacon.com/simicska-orban-planned-buy-independent-tv-station-russian-money/>

only partly accepted these arguments, gave the project a green light only under some specific conditions in order to avoid market distortions from state-aid²⁷⁴.

In the case of public procurement (lack of tendering), the Commission started an infringement procedure, but closed it in November 2016. Hungary successfully applied the so called „technical exclusivity exemption”, proving that only one company can fulfill the technical and safety requirements²⁷⁵. This practice was often referred in French projects and shielded the Hungarian decision efficiently as a precedent. At the same time the project partners were obliged to tender the subcontracts as much as it is possible, but at least up to 55% of the project value. The third disputed element was the government bill accepted in March 2015, exempting the project, its past and future documentation from the Freedom of Information Act and classifying all information for 30 years. Nonetheless, this issue was not closely related to project management and the government had to gradually retreat in several respects under legal pressure.

Thus by early 2017 the EC gave green light to the project and the construction depended exclusively on the two sides. One would have expected, that the permitting process will be relatively fast and preparatory construction works can begin in late-2017 – early 2018, as anticipated by senior governmental managers. At the same time by early 2019 Rosatom did not even submit the documentation for the permitting process. While all stakeholders deny the delay or refer to the EU approval process, the Hungarian side requested a renegotiation regarding the financial conditions. Problems around technical and regulatory details may have also surfaced, causing debates around the technological content of the contract. Currently no one expects the construction to start before late 2020, causing articulated anger in Moscow but cautious silence in Budapest.

As far as the financial conditions regarded, the Hungarian side publicly signaled its dissatisfaction with its interest rates. According to Hungarian governmental officials, more favorable financing is available on the market, thus Budapest would like to by-pass the Russian credit-line or renegotiate it²⁷⁶. In February 2017 Putin signaled that renegotiation is possible and offered some alternatives, among others proposed to raise the Russian credit from 80% share to 100% of the project value. Another related issue is the timing of the credit line, according to which repayment shall start no later than 2026, independently from the status of the construction. Due to the obvious delay, this point shall also be modified, even if no information is available in this regard. It is not surprising that the Hungarian side has not taken significant amount of the credit-line, and even these sums were repaid as soon as possible.

Nonetheless, the debates around the credit line represent the more visible, but less important disputes around the project. Technical and regulatory tensions may handicap the project management even more. Rosatom’s Finnish „twin-project” of the Paks expansion, the construction of the Hanhikivi-plant was postponed by four years until 2028. The local project company, Fennovoima, owned partly by Rosatom, could not prove the design’s safety at the Finnish nuclear regulator, STUK²⁷⁷. What is more, STUK ordered a confidential overview about the organizational and safety culture within the

²⁷⁴ „State Aid: Commission clears investment in construction of Paks II nuclear power plant in Hungary”, European Commission press release, 6 March 2017. Available at: http://europa.eu/rapid/press-release_IP-17-464_en.htm (20 February 2019).

²⁷⁵ „Hungary’s Paks II project clears procurement hurdle”, World Nuclear News, 22 November 2016. Available at: <http://www.world-nuclear-news.org/NN-Hungarys-Paks-II-project-clears-procurement-hurdle-22111601.html> (20 February 2019).

²⁷⁶ „Minek kellett az orosz hitel, ha rögtön visszaadjuk?”, Index.hu, 7 February 2018, Available at: https://index.hu/gazdasag/2018/02/07/paks_orosz_hitel/ (20 February 2019).

²⁷⁷ „Setback for nuclear industry as Hanhikivi Power Plant is delayed by a further four years”, Helsinki Times, 27 December 2018, Available at: <http://www.helsinkitimes.fi/finland/finland-news/domestic/16064-setback-for-nuclear-industry-as-hanhikivi-power-plant-is-delayed-by-a-further-four-years.html> (20 February 2019)

Russian nuclear industry. The report²⁷⁸ made alarming statements regarding the internal conditions and attitude towards safety. Partly on this basis STUK prolonged the permitting process by one year in 2017, and the Fennovoima consortium failed to deliver the necessary documentation even by this extended deadline.

The Finnish and Hungarian reactors' design, the AES-2006 model, had not been built at the time of contractual arrangements. Currently there are only two blocs that are on-line, the Novovoronezh II-1 and the Leningrad II-1, both in Russia. There is little to be known about its safety and functioning, these gaps complicate the regulatory process significantly. European safety regulations represent another problem. Within the EU and especially after the 2011 Fukushima-disaster the safety regulations became considerably stricter, raising the project costs compared to non-EU projects. Russia has never constructed nuclear plants within the EU territory, in many regards this is a first encounter for them (except some life-time expansions and upgrading in the new EU-member states). It remains unclear whether these aspects are duly taken into account at the contracting. The criticism in these regards is dismissed by the Hungarian government, saying that two turnkey nuclear blocs have been purchased from Russia, all the delivery risk is on the supplier's side. Nonetheless, the technical content has not been negotiated by the time of signature and there is no information how the contracts divide the related management and regulatory risks. Imre Mártha, former CEO of MVM Zrt., wrote in a leaked private letter to Mr Süli, minister in charge for the Paks2 investment in 2018 that the Paks2 contract was a Russian dictate and that Russia is not in possession of designs for the plant that comply with European Union regulation. He also claimed that myriads of small technical details have to be changed to fulfill EU requirements and this boosts the project's cost²⁷⁹. Indeed, in Vietnam Rosatom offered similar AES-2006 units at a 15-20% lower price, even if this happened some years before the Hungarian contract (in 2016 Vietnam denounced these projects). Thus these aspects may cause huge cost overruns and even derail the whole project.

At the same time the delay and the obvious non-action of the last two years is very telling about the underlying major tensions within the project. The Russian side urges the Hungarian government to launch the construction process as soon as possible. According to Rosatom the permitting process can run parallel to the construction²⁸⁰, thus some works at the field could happen right now. Rosatom has already ordered the turbines and the process control system for approximately 1.3 billion EUR. Nonetheless, PM Viktor Orbán in September 2018 underlined that the deadlines were not as important, but the security and successful project management was crucial for all sides²⁸¹. Until now, the spent funds have remained relatively small especially if compared to the total project value. This is the last point where the Hungarian government may „stand firm” without investing huge funds into an uncertain and highly risky endeavor. Consequently, Hungary's play for time is understandable.

For Russia the Paks2 project does not bear major financial risk. Even if according to the Hungarian sources Rosatom shall deliver two turnkey blocs by a particular deadline, little credibility can be given to these statements. The Russian side urges the launch of the construction, because its wish to reach a „point of no return” in the project. Rosatom has Hungary's legal obligation, signed construction

²⁷⁸ Marja Ylonen, Heli Talja, Nadezhda Gotcheva and Merja Airola: „Evaluation of safety culture of the Hanhikivi-1 project key organizations: Fennovoima, RAOS Project and Titan-2”, 13 March 2017, Available at: <http://www.stuk.fi/documents/12547/207522/1731883-loppuraportti-fh1-turvallisuuskulttuurin-riippumaton-arvio-2017-vtt-julkiset-osat.pdf/8fcdf721-52de-2e00-33ce-2486a75a7a91> (20 February 2019).

²⁷⁹ Györgyi Balla: "Kedves Jani!" – a volt MVM-vezér utolsó figyelmeztetője a Paks II.-ért felelős Süli Jánosnak 20 November 2018, hvg.hu, Available: https://hvg.hu/gazdasag/20181120_paks_2_martha_imre_levele_suli_lajosnak

²⁸⁰ András Szabó: „Kockázatos változtatásra készülnek Paks2-nél, ami az oroszoknak kedvezhet”, 22 February 2019, Direkt36, Available: <https://444.hu/2019/02/22/kockazatos-valtoztatasa-ra-keszulnek-paks2-nel-ami-az-oroszoknak-kedvezhet> (24 February 2019).

²⁸¹ „Orbán Viktor - Vlagyimir Putyin sajtótájékoztató”, 18 September 2018, Available at: <https://www.youtube.com/watch?v=YLo6rRlw320> (20 February 2019).

contracts and both their fulfillment or Budapest's exit may bring them financial reward. If the Orbán-government would like to postpone the project implementation, they can only hide behind regulatory details and refer to safety and technical weaknesses of the Russian design.

Gas imports and the Romanian gas transit issue

Hungary holds a long-term gas supply contract (LTSC) with Gazprom since 1994. The contract was originally signed for 20 years, but due to decreasing Hungarian import volumes and the Sides' consent it has remained in force even today, until the end of 2020. It has been modified several times and these changes reflected both the evolving European gas market realities and the shifting political and local sectoral trends. Nonetheless, the sides would like to conclude a new LTSC, valid from 2021 and this is a major opportunity for a grand renegotiation of the terms.

What makes this renegotiation process different from past rounds is the emergence of a new, medium-size source within the region: Romanian Black-sea shelf production may reach 6 bcm in the next 3-5 years. OMV and ExxonMobil develops the Domino and Pelican South gas fields, which hold proven reserves between 61 and 107 bcm combined. In order to market these volumes regionally, make them accessible outside Romania, the BRUA (an acronym for Black-sea-Romania-Hungary-Austria) pipeline project was designed with a total future capacity of 4.4 bcm between the fields and the Austrian CEGH (Baumgarten) hub. This is a major European project of regional importance: more than half of the total investment cost for the Romanian section (479 million EUR) was provided by various grants and credits of European entities²⁸².

The two processes, the development of Romanian gas fields and the renegotiation of Russian LTSC affect the Hungarian medium-term gas futures tremendously and offer optionality in these regards. Prospective volumes from Romania roughly equal to the current amount of gas imported through the Russian LTSC (between 4.5 and 5 in 2016-18), diminishes Gazprom's quasi-monopolistic market power and increases competition. Unlike Poland, a full offset of Russian gas imports is neither a goal, nor a possibility. What the Orbán-government would like to achieve, is the validation of its „Hungary first” principle, maximizing the sectoral and other economic benefits from this situation. This assumes relatively tough bargaining in both respects, in order to have the best terms possible. Nevertheless, the Orbán-government would like to maintain cooperation both with Gazprom and the Romanian Black-sea gas operators, ExxonMobil and OMV.

The „Hungarian entry” into this regional gas game came in July 2017, when the gas TSO, FGSZ abandoned the original concept of BRUA. This assumed the building of a dedicated, new pipeline from the Romanian border to Austria. At the same time, according to FGSZ (gas TSO) the existing Hungarian network was sufficient to transit the whole volume through Hungary and Slovakia to Baumgarten. This argumentation rested on the fact that, despite the longer route, but through an already existing system, the transit capacities could be contracted long-term at competitive fees. Within the Hungarian gas community for many years the underutilization of the existing network has been the most onerous problem and the construction of a new pipeline seemed to be absurd.

Nonetheless, the move enjoyed wider sectoral and political support. According to the original BRUA plans, the Hungarian role was constrained to transit and access to Romanian gas depended on negotiations with suppliers, most likely with OMV and ExxonMobil. The best what Hungary could hope for was some gas on a „Baumgarten netback” (the Baumgarten price minus some transit fees) basis. At the same time Hungary wanted to get better access to a larger amount of gas and even more importantly to play a distributor role within Central Europe. According to these arguments there was no sense to deliver natural gas to Austria back and forth, when it can be marketed in Hungary, Serbia, Croatia, Ukraine or Slovakia, markets lying much closer to the shipping route. Thus, even if the

²⁸² Among others the EBRD, EIB and the Commission provided the funds.

Hungarian section of the BRUA pipeline were built, its costs would be included into the gas price irrespective of its utilization and the real delivery services.

PM Viktor Orbán also wanted to have a stronger bargaining position and use the transit leverage to the benefit of Hungarian companies. In this new setup the auctioning of the pipeline capacities, both at the Hungarian-Romanian and the Hungarian-Slovak border was managed within the Hungarian jurisdiction. The former was preliminary given to MET and MVM, two major players on the Hungarian market, while the latter was auctioned on a long-term basis for a variety of companies²⁸³. This is in contrast with the original BRUA-concept, envisaging collective auctioning of the total capacity likely to OMV and ExxonMobil. In this regard the two firms did not have other option than to negotiate about the terms of transit through Hungary and get access through the local auctioning procedures. The move was more painful for OMV, who had the marketing infrastructure within the region and wanted to boost its regional hub, the CEGH, by these incremental volumes.

Both solutions have its benefits and risks. The original BRUA-project with its dedicated pipeline represents a more expensive model which likely brings the Romanian gas further away from the SEE and CEE regions. At the same time, it includes less stakeholders, provides marketing through established channels, even if these to a larger extent depend on the OMV's economic interests. The alternative Hungarian proposal would potentially offer distribution within the region through the existing network with long-term contracting of the pipeline capacities. Gas can be potentially cheaper, but substantial volumes will remain in Hungary or will be marketed by Hungarian companies either. Instead of relying on the OMV's financial rationale, PM Viktor Orbán and the Hungarian political-economic reality may influence the means of marketing.

The LTSC renegotiation process with Gazprom depends largely on the outcome of Romanian gas development prospects. In the past Hungary had an inflexible import volume necessity, consequently bargaining about prices and conditions was difficult and the negotiations one-sided. This may change, once Hungary will have contracts for Black-sea gas and access to its flows. Gazprom pricing may influence import volumes and Hungary can optimize its gas import policy better. Thus it is likely, that Budapest would like to harmonize the two processes. Thus hesitation about Romanian Black-sea gas development makes Budapest nervous and affects its Russia-connection indirectly. Much of the Hungarian anxiety regarding Romanian legal disputes are related to the growing time pressure²⁸⁴. Budapest shall conclude a new LTSC with Gazprom until the end of 2020 as latest, while the current postponement of Black-sea FIDs create a major source of uncertainty.

The regional gas landscape may further improve due to the FID regarding the Krk LNG-terminal in Croatia in January 2019. The project failed to get enough bids for the capacity, thus it will be constructed on a non-market basis by significant EU-support (a grant of 101.4 mln EUR in 2017) and state-ownership. While Atlantic LNG prices are currently not competitive in CEE and the small capacity of the terminal (up to 2.6 bcma) is not a full-fledged alternative for current pipeline networks, the sheer existence of an access to this source may increase local resilience substantially. Fast construction of the Krk LNG-terminal may also bridge some of the delay in Black-sea gas development.

²⁸³ The Hungarian-Slovak cross-border capacity (4.3 bcma) was fully booked between 2022 and 2029 and partly until 2037. As for the Hungarian-Romanian cross border point, the preliminary booking procedure failed in December 2018, the respective companies gave back their offer due to the postponement of the Black-sea offshore gas FID decisions.

²⁸⁴ In June 2018 foreign minister Péter Szijártó called for increasing pressure on Romania to enable the development of the Black-sea deposits. „Román-magyar gázháború: sorsdöntő napok jönnek”, Portfolio.hu <https://www.portfolio.hu/vallalatok/roman-magyar-gazhaboru-sorsdonto-napok-jonnek.291302.html> (18 March 2019).

The South Stream lite

Despite the strong statements from the Kremlin regarding the cancellation of the South Stream pipeline after December 2014, the project has not disappeared totally in the subsequent years. In different names and forms (Tesla, development of national sections) the idea and some official discussion remained present within the region. Hungary has been actively involved in these preparations, even if its enthusiasm diminished to a certain extent.

Despite Fidesz' harsh criticism of the South Stream project in opposition prior to 2010, it became one of the pet projects in the Hungarian-Russian relations by 2014. Due to the fall of Nabucco-West in mid-2012, South Stream remained the last transit project standing for Hungary. It promised a significant volume of annual transit around 30-32 bcma, 4-5 times the total import volume of the country. Budapest was in the midst of sensitive negotiations with Moscow, and South Stream seemed to be one of those few issues, where Hungary was on Russia's demand side. Similar to Sofia and Belgrade, it also took a considerable conflict with the EU during the preparations and the cancellation of the project was a surprise for many decision makers.

The cancellation, its unexpected announcement was a serious blow for Russia's credibility in pipeline matters. In different ways, but this issue remained sensitive both in the Bulgarian and Serbian relations and handicapped further cooperation. Moscow tried to re-engage Belgrade and by-pass Sofia in mid-2015 with some support from Budapest in the Tesla-project, unsuccessfully²⁸⁵. Gazprom was also occupied with the Nord Stream 2 project in these years, thus the SEE region remained relatively peaceful until late 2017.

Hungary remained relatively supportive to Russian attempts to revitalize pipeline projects in the SEE region. PM Viktor Orbán criticized the EU for the failure of the South Stream, especially when compared to Nord Stream construction works²⁸⁶. Hungary also tried to lobby for the Tesla-pipeline, allegedly proposed by Gazprom and interconnecting Turkey with Austria through Greece, Macedonia, Serbia and Hungary²⁸⁷. This pipeline would have facilitated both Azeri and Russian gas shipments to the North, but the initiative failed to get considerable support²⁸⁸. Not surprisingly in July 2017 FM Péter Szijjártó signed a memorandum on establishing a cross-border capacity with Serbia in Moscow and announced Hungary's readiness to join the Southern Gas Corridor after Bulgaria and Serbia²⁸⁹. This was Budapest's formal move to join the activities that can be labeled as „South Stream lite”. Unlike South Stream, Gazprom's current attempt rests on national sections and their respective regulation in national capitals. The total volume of shipment would be around the capacity of a single line of Turkstream, much below 16 bcma (at the Serbian-Hungarian border around 8 bcma), four times less than envisaged by South Stream a couple of years before. The project preparation keeps a very low profile, with much less visible representation from the Russian side.

²⁸⁵ „Greece, Serbia, Hungary, FYROM to sign memorandum on the construction of the pipeline, which should connect the Turkish Stream pipeline with Austria”, New Europe, 20 August 2015, Available from: <https://www.neweurope.eu/article/russia-pushes-tesla-pipeline-through-balkans/> (24 February 2019).

²⁸⁶ „Tárgyalások kezdődnek a 2021 utáni gázszállításról”, 2 February 2017, Available from: <http://www.kormany.hu/hu/a-miniszterelnok/hirek/megbecsulendo-a-magyar-orosz-egyuttmukodes> (25 February 2019). „Orbán Viktor kormánya az Északi Áramlat-2 pártján áll”, 28 August 2018, Available from: <https://uj szo.com/gazdasag/orban-viktor-kormanya-az-eszaki-aramlat-2-partjan-all> (25 February 2019).

²⁸⁷ „CE/SEE Partners Eye EU Funds for Tesla Gas Pipeline Project”, Available from: <https://www.iene.eu/cesee-partners-eye-eu-funds-for-tesla-gas-pipeline-project-p2055.html> (25 February 2019).

²⁸⁸ Partly because of lack of credibility and also due to its high costs.

²⁸⁹ „Szijjártó: 2019 végéig csatlakozunk a déli gázfolyosóhoz”, Available from: https://index.hu/gazdasag/energia/2017/07/05/szijjarto_2019_vegeig_csatlakozunk_a_deli_gazfolyosohoz/ (25 February 2019).

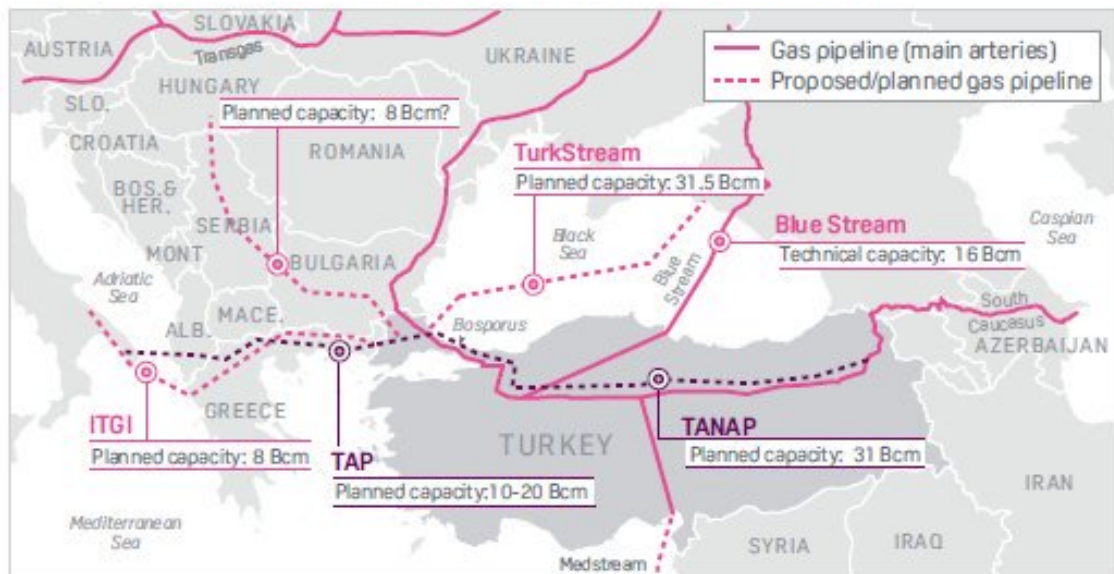


Figure 3. Map: Pipelines in the Black-sea and SEE region (the discursive line through Bulgaria and Serbia represents the likely route for “South Stream lite”)

Source: Platts

Despite its supportive attitude, the Orbán-government’s expectations remained rather low regarding the Southern interconnection. One of the reasons is the small magnitude of this renewed effort: the total cross-border capacity established on the Southern border would equal to max. 8-9 bcma, only slightly more than the total Hungarian import volume. If we add that Hungary would lose Gazprom’s current transit to Serbia (between 1.5 and 2 bcma), no significant financial benefit will come from South Stream lite. Hungary may be supplied from the South instead of Ukraine, but transit volumes will be less than before. Second, unlike the situation in 2013-14, this time Hungary has a strong bargaining chip, the Black-sea gas. Budapest does not have to win Moscow’s goodwill so desperately, it has more autonomy to form its balance. Third, Hungary has already experienced both the fiasco of South Stream and Tesla in less than five years. Consequently there is considerable fatigue and inflated credibility of Russian pipeline projects. Budapest would like to see more action in Bulgaria and Serbia before taking final decisions in details. Gazprom’s low profile in the project does not help in this regard.

Hungarian receptivity stems from a number of various considerations. The national gas community is satisfied with the current Ukrainian transit route, but cannot ignore the high level of uncertainty regarding its future. Nord Stream 2 is seen as a highly unfavorable route for future Hungarian supply: as many regional gas TSOs and companies, it has been feared that development costs and high German transit fees will increase the import prices in the longer run. Nord Stream 2 does not offer any benefit for Hungary and assumes a relatively costly network adaptation process. In March 2016 the Hungarian government, together with seven other CEE states publicly criticized the Nord Stream 2 initiative as being a risk for energy security within the region, destabilizing the geopolitical situation²⁹⁰. This move was further emphasized by regulative measures, not allowing the long-term auctioning for Gazprom of the Austrian-Hungarian and Slovak-Hungarian cross-border capacities. The later one would be needed for Romanian Black-sea gas exports in a reverse mode, thus making the two projects, Hungarian transit from Romania and supply from the Nord Stream 2 incompatible with

²⁹⁰ „EU leaders sign letter objecting to Nord Stream-2 gas link”, 16 March 2016, Reuters, Available from: <https://www.reuters.com/article/uk-eu-energy-nordstream/eu-leaders-sign-letter-objecting-to-nord-stream-2-gas-link-idUKKCNOWI1YV> (27 February 2019).

the current network. Practically this represents a considerable pressure on Gazprom to solve the Hungarian supply from other directions and leave the Nord Stream 2 option only for emergency cases.

Thus „South Stream lite” and the related Turkstream project are perceived as the lesser of two evils. Understandably the Hungarian government cannot fully ignore Russia’s wish for alternative supply routes. At the same time it may set a number of conditions during its implementation. These include issues related to more favorable conditions regarding the LTSC conditions, ownership and marketing conditions of the new pipeline and the respective shipments, but also can ask for a considerable role in the project. For the later, the emergence of MET, the Hungary-related Swiss trader among the shippers of the Bulgarian section of „South Stream lite” are highly indicative in this regard²⁹¹.

Outlook

Hungary’s moderate detachment from strong cooperation with Moscow is full of contradictions. Most importantly, the Orbán-government conducts this move only half-heartedly. Budapest continues its quest for bilateral economic and energy benefits and does not have clear priorities in the major sectoral issues. Furthermore, the current regional landscape and developments make good relations with Moscow and energy diversification barely reconcilable. Both the development of Romanian gas deposits and even the Croatian LNG-terminal imply considerable tensions with Gazprom. Certainly, Moscow will test Hungary’s resilience in these matters whether by sticks or carrots. It may be increasingly difficult for the Orbán-government to find a balance between old and new suppliers. The heavily criticized move to offer Budapest as the headquarters for the International Investment Bank²⁹² might be a step to compensate for the detachment in the energy sector.

At the same time the current statist Hungarian sector hides a high number of vulnerabilities. It remains highly sensitive regarding price issues due to the government’s past populist measures in the residential sector. Current utility prices constitute a major political taboo, the government cannot raise the tariffs despite considerable increase in import prices. MVM weak financial liquidity and lack of funds for appropriate preparations for the winter seasons likely played a major role in Hungarian requests to use the Hungarian storage system by Gazprom in 2014 and 2017²⁹³. The autumn 2014 supply cut on the Hungarian-Ukrainian border may have also been related to Moscow’s requests, while there were no technical reasons for it²⁹⁴. Nevertheless, the Paks2 deal remains by far the biggest bugset of management problems. Obviously the Hungarian government realized the challenges of the projects and would like to retreat in many regards. At the same time most of the contracts have been already signed, thus any kind of postponement or cancellation means an uphill battle for Budapest.

In the current centralized design, all these issues are interrelated. It was PM Viktor Orbán who wanted to raise all these energy issues to the highest bilateral level. Accordingly, he has to take the responsibility for all the negative developments and Moscow’s criticism. Not surprisingly, bilateral relations have been hollowing for a while and Budapest actively tries to decrease their intensity. While Putin and Orbán met twice both in 2017 and 2018, their 2019 meeting has been postponed until

²⁹¹ „Bulgaria will build pipeline to transport Russian gas”, 31 January 2019, Reuters, Available from: <https://www.reuters.com/article/bulgaria-gas/update-1-bulgaria-will-build-pipeline-to-transport-russian-gas-idUSL5N1ZV6EN> (27 February 2019).

²⁹² The Russian-inspired International Investment Bank moves to Budapest. 3 March 2019, Hungarian Spectrum. Available: <http://hungarianspectrum.org/2019/03/03/the-russian-inspired-international-investment-bank-moves-to-budapest/>

²⁹³ 700 and 898 million bcm of gas was injected in 2014 and 2017 respectively with a buy option from the Hungarian side.

²⁹⁴ „Az EU és Ukrajna is rossz néven veszi, hogy nem adunk gázt az ukránoknak”, 444.hu, Available at: <https://444.hu/2014/09/26/az-eu-es-ukrajna-is-rossz-neven-veszi-hogy-nem-adunk-gazt-az-ukranoknak> (18 March 2019)

autumn, allegedly because of Hungarian request. It still has to be seen, how Hungary can benefit from the most advantageous regional gas landscape for decades, bearing all the burden of its past commitments to Moscow.

RECOMMENDATIONS

- Besides infrastructure development, the EC shall **turn more intensively towards major local production projects**. It may provide a broader set of technical and consultancy support from an earlier phase. While these remain sensitive issues, early-phase support on expert or administrative level may facilitate better outcomes later, on the political level. This activity may be transferred also to the Energy Community and achieve broader geographic cover.
- The EU shall consider what it can do in order to **decrease uncertainty regarding medium- and long-term planning in the gas and particularly in the electricity sectors**. While uncertainty is a major issue everywhere in the continent, it may raise future energy prices and in CEE and SEE region it constitutes a major asset for Russian (and in some cases Chinese) influence. Fears from future electricity supply scarcity increases self-sufficiency ambitions, opening major windows for Moscow.
- **Demand-management and policies regarding efficiency remain very weak** through the region. Arguments about future demand growth and supply-driven logic in energy policy favors Russian presence. The EC shall start more dedicated efforts in order to achieve shifts in regional sectoral planning and bring best practices from more progressive countries to these national capitals.
- **Direct funds towards renewable energies, regional EU energy projects can contribute to diversifying the energy portfolios** of EU MSs, strengthen ties/dependencies within EU countries stronger.