

**Serbia and the Russia–Ukraine War:
Implications and Challenges II.**

Az orosz-ukrán háború és Szerbia:
következmények és kihívások II.

DÁNIEL HARANGOZÓ



KKI Policy Brief

Series of the Institute for Foreign Affairs and Trade

Publisher:

Institute for Foreign Affairs and Trade

Reviewed by:

Julianna Ármás, Ferenc Németh

Typesetting:

Tamás Lévárt

Editorial office:

H-1016 Budapest, Bérc utca 13-15.

Tel.: + 36 1 279-5700

E-mail: info@ifat.hu

<http://kki.hu>

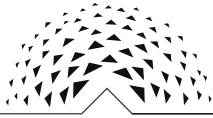
The present analysis and its conclusions reflect the author's opinion and cannot be considered the official position of the Institute for Foreign Affairs and Trade, the Ministry of Foreign Affairs and Trade, or the Government of Hungary.

© Dániel Harangozó, 2022

© Institute for Foreign Affairs and Trade, 2022

ISSN 2416-0148

<https://doi.org/10.47683/KKIElemzesek.KE-2022.65>



Abstract: The outbreak of the Russia-Ukraine war in February 2022 has had a marked effect on the Western Balkan region. Among the countries of this region, Serbia is in a unique situation due to its military neutrality, and the fact that it follows a balancing foreign policy between the Western powers on the one hand, and Russia, Turkey, and China on the other hand, also maintaining close political, economic, and security ties with the latter two powers. The second part of the paper continues to review the consequences and challenges of the war on Serbia by examining the energy domain. Russian exposure in Serbia's energy sector, apart from the near-total reliance on Moscow for gas imports, is compounded by the fact that the most important oil company of the country, Naftna Industrija Srbije (NIS) is majority-owned by Gazprom Group. As with other countries in the Central and Eastern European region as well as wider Europe, the diversification of sources and decreasing the reliance on Russian energy will take considerable time for Serbia. Cooperation both with Serbia's neighbours and the countries of the region (e.g. Bulgaria and Greece) will play a significant role in the diversification of both sources and supply routes.

Keywords: Serbia, energy supply, energy security, international sanctions, Russia-Ukraine war, Western Balkans.

Absztrakt: A 2022 februárjában kitört orosz-ukrán háború a Nyugat-Balkán államaira is jelentős hatást gyakorolt. A térség államai között sajátos azonban Szerbia helyzete. Az ország katonailag semleges és külpolitikájában a szerb kormány a nyugati hatalmak, illetőleg Kína, Törökország és Oroszország között „egyensúlyozó” irányvonalat folytat, és közeli politikai, gazdasági, illetve biztonsági-katonai kapcsolatokat is fenntart ezen államokkal. Elemzésünk második részében, építve az előző elemzésben leírtakra, a háború szerbiai következményeinek vizsgálatát egy újabb jelentős területtel, az energetikával folytatjuk. Szerbia számára az energiaellátás orosz kitettséget, a gázimport területén meg nyilvánuló gyakorlatilag teljes orosz függőség mellett az a tény is növeli, hogy az ország legfontosabb olajvállalata, a Naftna Industrija Srbije (NIS) a Gazprom-csoport többségi tulajdonában van. Európa, illetve a kelet-közép-európai térség többi országához hasonlóan a beszerzési források diverzifikálása és az orosz energiafüggőség csökkentése Szerbiában is jelentős időt vesz majd igénybe. Mind a források, mind pedig a szállítási útvonalak diverzifikálása terén a szomszédos és régiós államokkal (pl. Bulgária és Görögország) való együttműködés jelentős szerepet játszik majd.

Kulcsszavak: Szerbia, energiaellátás, energiabiztonság, nemzetközi szankciók, orosz-ukrán háború, Nyugat-Balkán.

INTRODUCTION

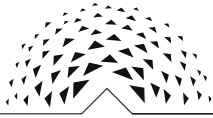
The outbreak of full-scale war between Russia and Ukraine in February 2022 has led to the intensification of the energy crisis in Europe that had already started in autumn 2021, several months before the war. The causes of this crisis were manifold, including a slow recovery of the energy supply after the COVID-19 pandemic, insufficient investment in the energy sector in the previous years, adverse weather conditions, and the reduction of Russian gas exports to Europe. The war has not only caused energy prices to increase further but also the emergence of concerns about security of supply. The countries that have enacted economic sanctions against Russia or provided military support to Ukraine now face the threat that Moscow will use its energy exports (mostly of natural gas, but to a lesser extent also crude oil and oil products) as a tool of retaliation or a source of political leverage. In the case of Serbia, a country with close economic ties to Russia in the field of energy in particular, the question of energy security has acquired a somewhat different nature. The country has not joined the EU sanctions against Moscow, in part due to its Russian energy dependence, and the threat that the Russian “energy weapon” will be used to compel Belgrade not to change its stance on EU sanctions.

It is also important to mention that the Serbian energy sector was already facing considerable challenges before the war, such as the [electricity crisis](#) in late 2021, and the financial [problems](#) of the state electricity company *Elektroprivreda Srbije* (EPS). These problems have been further exacerbated by the significant price increases and security of supply concerns brought about by the war.

The present paper is divided into three main parts. First, the main features and problems of Serbia’s energy sector are briefly reviewed using data from the Energy Agency of the Republic of Serbia (AERS) and available press reports. The second and third parts analyse the issue of the country’s natural gas and oil supply after the war, in particular, the effect of international or EU sanctions, the role of Russia as a supplier in the post-invasion period, and the efforts to diversify supply sources. The discussion of the post-invasion energy situation will be mostly limited to the supply of natural gas and oil, partly because Russian exposure is present in the case of these two resources. Issues related to the electricity market will be dealt with only tangentially.

SERBIA’S ENERGY SECTOR PRIOR TO THE WAR

The Serbian energy sector can be characterized by significant exposure to Russian supplies in recent years (particularly in the case of gas), the important role of state-owned entities (particularly in the field of electricity generation and distribution, and natural gas distribution), and persistent financial and governance problems.



Regarding *natural gas*, the country is almost completely dependent on import. According to AERS [data](#), only 7.9% of the gross natural gas consumption of 2,883 million m³ was covered by local production in 2021. In that year, imported gas was practically only procured from the Russian Federation, based on long-term contracts (2,294 million m³ out of 2,444 million m³ imported). Industry and other (64%) and district heating companies (23%) were the largest [consumers](#) of gas in 2021, while households only accounted for 13% of final consumption. The country has one [underground gas storage](#) facility at Banatski Dvor, with a total capacity of 450 million m³, about 15 percent of Serbia's 2021 consumption. Currently the main import [route](#) of Russian gas is the [Balkan Stream](#) pipeline, which transits through Bulgaria. The Niš-Dimitrovgrad-Sofia gas pipeline, designed to connect Serbia to the gas pipeline network of Bulgaria and Greece, is [under construction](#) and [expected](#) to become operational in October 2023. Serbia's previous long-term gas supply agreement with Russia, which had been [due to expire](#) in 2021, was [extended](#) until May 2022 after President Vučić's visit to Moscow in November 2021.

Serbia's *oil* sector is [dominated](#) by *Naftna Industrija Srbije* (NIS), in which Gazprom Neft of Russia (a member of Gazprom Group) holds a 56% majority stake, while the Serbian government remains a minority owner of the company with a 30% stake. Beside a virtual monopoly of oil refining, the company is also active in oil production, which in 2020 [covered](#) about 21% of domestic consumption, the rest being sourced from import. In the same year, two-thirds of imported oil [originated](#) from Iraq, 23% from Russia, and 10% from Kazakhstan. Most of the imported oil is [transported](#) to the country via the Adria pipeline system (*Jadranski naftovod*), which runs from the Croatian oil port of Omišalj to the main Serbian oil refinery at Pančevo, with an important terminal in the city of Novi Sad.

Most of the *electricity* generated in the country is produced by coal-fired thermal power plants (TPP). Generally, these plants use lignite as a heating fuel, which has a lower heating value and contains more air pollutants than black coal. In 2021, 52% of the installed [generation capacity](#) consisted of coal-fired TPPs, 34.5% of hydropower plants, 6.2% of gas and oil-fired combined heating and power plants (CHP), and 4.4% of wind power plants. If the actual [production figures](#) are considered, the dominance of coal is even more pronounced: out of the electricity generated in 2021, coal-fired power plants accounted for a 60.4% share, while hydropower was responsible for 32.5%, with the remainder divided between wind power and gas or oil-fired CHPs.

Most of the coal-based thermal power infrastructure is technologically obsolete, and modernization efforts (e.g. the [third block](#) of Kostolac B TPP) have been [delayed](#) in part by [debates](#) about the advisability of investing in new coal-fired power generation capacities. Technological problems, along with the mismanagement of the state-owned company EPS, was one of the causes of Serbia's [electricity crisis](#) in the winter of 2021. The use of low-quality

and contaminated heating coal led to a [series](#) of [outages](#) in Serbia's two main thermal power plants, Nikola Tesla A and B, between 8 December, 2021 and 12 January, 2022. The resulting electricity shortfall forced the state-owned operator to institute blackouts in some parts of the country, and to import additional electricity [at a high cost](#). Between the last quarter of 2021 and the first quarter of this year, EPS spent nearly EUR 500 million on these imports.

One of the main reasons for the persistent financial problems of state-run energy providers is the [low level](#) of regulated energy tariffs, particularly in the residential sector. These prices were initially unchanged, despite the significant increase of energy prices across Europe in autumn 2021. According to the [Household Energy Price Index](#) for Europe, Belgrade had the second-lowest residential electricity price of the 33 European capitals surveyed in February 2022. Regarding natural gas, the Serbian capital had the third lowest price level.

SUPPLY OF NATURAL GAS: BETWEEN RUSSIAN DEPENDENCE AND ATTEMPTS AT DIVERSIFICATION

After the outbreak of the war, the main challenge for the country regarding natural gas was the looming deadline to renew its long-term gas supply agreement with Russia, which was due to expire in May, in an environment of radically increased prices and concerns about the security of supply. Part of the reason why the country refused to align with the EU sanctions introduced against Moscow was the aim to conserve political room to manoeuvre in the negotiations with its main supplier. The new agreement, [signed](#) at the end of May this year, can be considered a partial success of this Serbian policy. The pricing will continue to be linked to the price of oil, which at the time of signature amounted to USD 340-350 per 1,000 cubic meters, about 30 percent higher than the USD 270 stipulated in the previous contract, but still substantially below the prevailing European market price level, around USD 900 at that time.

It is important to point out, however, that the [contracted volume](#) of 2.2 billion cubic meters is significantly [less than](#) Serbia's annual consumption of around 3 billion cubic meters. Both the fact that in the long-term agreement, gas is sold at a significant discount compared to the prevailing market price, and that additional quantities need to be imported to cover Serbia's consumption, give Moscow a certain amount of political leverage over Belgrade.

To cover part of the above-mentioned 800 million m³ shortfall, in early June 2022 Sinisa Mali, Serbian Deputy Prime Minister in charge of the Ministry of Finance [signed](#) an agreement with Hungary on the sale and subsequent storage on 500 million cubic meters of gas. Additional quantities of gas were also purchased [from Russia](#), albeit at a higher price than the one stipulated in the long-term agreement.



One solution to Serbia's gas supply problems will be the diversification of supply sources, to which the country looks to both Southeast European peers Bulgaria and Greece and energy-rich [Azerbaijan](#). The completion of the Serbia-Bulgaria interconnector, [expected](#) in the first half of 2023, together with the Bulgaria-Greece interconnector, which was [launched](#) this July, will open access to new suppliers. Belgrade has already signalled its [willingness](#) to import Azeri gas as soon as next year, but the new interconnector will also link Serbia to the Greek LNG hub of Alexandroupoli, which is expected to become an important LNG supply point for the whole of Southeast Europe. However, LNG currently carries a significantly higher price tag than pipeline gas, and given the insufficient supply due to the tightness of the global LNG market, LNG deliveries alone would not be able to completely replace the gas volumes imported from Russia.

The substantial increase of gas prices, along with the continuing need for electricity imports, represents a significant cost for the Serbian budget. [According to](#) the Serbian Fiscal Council, budgetary support to Srbijagas and EPS in 2022 will cost the national treasury up to EUR 2 billion. In September 2022, then Energy Minister Zorana Mihajlović said the country was [planning to](#) spend about EUR 3 billion (4.5 percent of Serbia's GDP) on electricity, coal, natural gas, and oil imports between October 2022 and March 2023.

This significant deterioration of Serbia's public finances, which were already under strain after the heavy spending during the COVID-19 pandemic, along with the recent increase in emerging market bond yields, explains why Belgrade first [signed](#) a loan agreement worth EUR 1 billion with the United Arab Emirates, and later [negotiated](#) and [signed](#) an IMF stand-by agreement on 2 November to replace its previous Policy Coordination Instrument (PCI) arrangement.

The intensification of the energy crisis makes the increase of domestic gas tariffs even more urgent: the state-owned gas company Srbijagas already [raised](#) gas prices by 9 percent on 1 August, and a further increase of [11 percent](#) has been [announced](#) from 1 January. The new tariffs, particularly those of residential consumers, are still substantially below the prevailing import costs. Further energy tariff increases will also probably be stipulated by the IMF stand-by agreement recently signed by Belgrade.

SUPPLY OF OIL: COLLATERAL DAMAGE OF THE EU SANCTIONS?

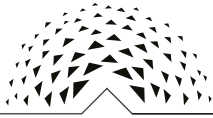
As mentioned above, Serbian exposure to Russia in the oil sector is composed of two elements: majority ownership of the oil company Naftna Industrija Srbije (NIS) by Gazprom Group (Gazprom Neft), and imports of seaborne Russian crude oil to Serbia through the Adria oil pipeline.

On 15 March, the fourth package of EU sanctions against Russia was adopted, prohibiting EU-based entities to do business with Gazprom Neft and its subsidiaries, which would have included NIS. However, Serbia and other states of the Western Balkans were granted an [exemption](#) from these provisions shortly after its adoption. The Serbian government already [recognized](#) in May that the Russian majority ownership of NIS presents a potential [legal](#) and energy security [risk](#). In search of a solution, among others, a buyout of Gazprom by the Azerbaijani state oil corporation (SOCAR) was [mooted](#). However, SOCAR later [denied](#) rumours that it was interested in acquiring the stake of Gazprom Neft. According to [Financial Times](#), another potential suitor was the Hungarian energy group MOL, even though talks on the sale have stalled.

Although the share of Russian crude oil in Serbia's oil imports had been decreasing since 2008, after the outbreak of the war, the country [increased](#) its imports from Russia, owing to the substantial discounts that could be achieved by purchasing Russia's Urals crude. Russian oil imports through the Adria pipeline first became a problem in late March, when the pipeline operator JANAF [threatened to suspend](#) transporting Russian oil supplies to Serbia, citing the fourth package of EU sanctions. At this time, the problem was resolved by granting Serbia, among others, the above-mentioned exemption. The second time this question came to the forefront was during the discussion of the eighth sanctions package of the European Union, partly meant to clarify the details of the implementation of the EU oil embargo, to enter into force on 5 December. On the issue of whether or not to grant an [exemption](#) to Serbia and the Western Balkans from the embargo, Croatia, among [others, lobbied against](#) the exemption. The issue was left out of the conclusions adopted on 6 October, with the final decision [postponed](#) to 1 December. However, until now, no final decision has been made.

Several [interpretations](#) have been put forward in the Serbian media for this course of events. Some explained the behaviour of Croatia by domestic political considerations, or the constant [tensions between](#) Serbia and Croatia (for example, the recent [controversy](#) around Vučić's [planned visit](#) to the Jasenovac concentration camp memorial site). Others [faulted](#) Belgrade's refusal to align with the EU sanctions regime.

As a stopgap measure, the linking of Serbia to the Druzhba (Friendship) pipeline in Hungary has been [proposed](#) in a meeting between the two countries on 10 October. As the EU oil embargo only applies to seaborne oil shipments, importing Russian crude through this pipeline system would theoretically be possible for Serbia. Experts point out several [problems](#) with this plan, however. One is the cost, of at least EUR 100 million, which would wipe out any savings achieved by importing the cheaper Urals crude from Russia. Second, the completion of the connecting pipeline would take at least two years, during which a lot could change in the geopolitical environment. Third, under the conditions of the EU oil embargo, the re-export of Russian oil from Hungary



may not be legally possible to third countries. Fourth, the long-term viability of the project is questionable, as the Druzhba pipeline itself is increasingly technologically obsolete. The possibility of a disruption of oil supplies from Russia through Ukraine due to the war also has to be considered.

CONCLUSION

As this paper has demonstrated, the outbreak of the war found the Serbian energy sector in an already vulnerable state, and the pre-existing difficulties have been exacerbated by the war.

Regarding natural gas, the main issue is Serbia's almost complete dependence on Russian imports, and the existence of a below market-priced supply contract, which Russia could exploit as a source of political leverage. It can be considered a success of Serbia's balancing policy that it was able to conclude another three-year Russian gas contract on advantageous terms in May 2022, a contract which, on the other hand, will give Russia continuing leverage over Belgrade. This is even more the case if we consider that the supply volumes agreed do not cover Serbia's annual consumption needs. For the 2022/23 heating season, an agreement with Hungary on the sale and stockpiling of 500 million m³ gas will help cover part of the shortfall, but this can only be considered a temporary stopgap measure, as the gas sold is also Russian in origin.

Given the access to the Balkan Stream pipeline and the existing (and competitively priced) long-term contract with Gazprom, it seems unlikely that Serbia will aim to completely replace Russian gas in the near future, unless Russia shuts down or severely restricts supplies, for example, in retaliation for an eventual Serbian adherence to the EU sanctions regime. The completion of the Serbia-Bulgaria interconnector, and thereby access to Azeri gas and LNG supplies via the Alexandroupoli LNG hub will, however, make it possible for the country to establish a more balanced supplier mix.

Regarding oil supply, the difficulties arise not so much from excessive dependence on Russian imports but rather from the EU's sanctions regime, even though Serbia is not (yet) a part of it. The fact that the country's main oil company is majority owned by Gazprom Group can, in the future, present legal problems for Belgrade, a question that the government already [recognized](#) back in May. Even more acute is, however, the uncertain fate of Russian crude oil imports through the Adria pipeline once the EU embargo on seaborne Russian oil enters into force. Here, during the discussion of the eighth sanctions package, Croatia successfully lobbied to not give an exemption to Belgrade, albeit no final decision has been made for the time being. Again, cooperation with Hungary (in the form of connecting Serbia to the Druzhba pipeline) is being mooted as a stopgap measure. However, the economic viability, or even technological or legal feasibility of this project in terms of the EU sanctions regime is doubted by many experts.

Given the fact that Russian crude oil supplies only constitute a part of Serbia's oil imports, the best course of action would be to give the country a time-limited exemption on Russian crude imports through the Adria pipeline (perhaps similar in length to the one Bulgaria secured for the import of Russian seaborne oil). However, political tensions between Serbia and Croatia may not make this option feasible.

It is also important to mention the role of [renewable](#) energy resources, a topic not dealt with in detail in this paper. [Hydroelectric, wind, and solar](#) power generation capacities, [under planning](#) or coming [online](#) in the next few years, will also contribute to strengthening the energy independence of Serbia and to lessening the dependence on Russian supplies.

Finally, although not directly related to the issue of Russian energy imports, but of no less importance, is the question of the structural reforms of Serbia's energy sector. As mentioned earlier, the long-term financial difficulties and governance problems mostly in the state-owned energy companies have made the impact of the present energy crisis even worse for the country. From this standpoint, it is an encouraging sign that the incoming government may start to take these problems seriously. In October 2022 an [agreement](#) was concluded between the government of Serbia and the noted consultancy Rystad Energy based in Oslo about the reform of the country's energy sector. Several senior members of the government, including the [President](#) and new Energy Minister Dubravka Đedović, have recently [spoken](#) about the need to reform the state-owned energy companies, e.g. Srbijagas or EPS. If the Serbian government can seize the opportunity and successfully carry through the reform of the energy sector of the country, that might be the only silver lining in the present crisis.