

# Hungary and Russia in economic terms – love, business, both or neither?

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## 1. Introduction

Hungarian-Russian relations have changed considerably during the last decade. In the mid-2000s, it was a limited and cautious relationship with many reservations on both sides. Being a “friend of (in those years much less authoritarian) Russia” was often perceived as something exceptional and was predominantly a radical leftist phenomenon in the public discourse. The political class was united in banning Russian investments from Hungarian strategic industries. Returning to Eastern markets seemed to be an old-fashioned leftist concept heavily criticised by conservative thinkers.

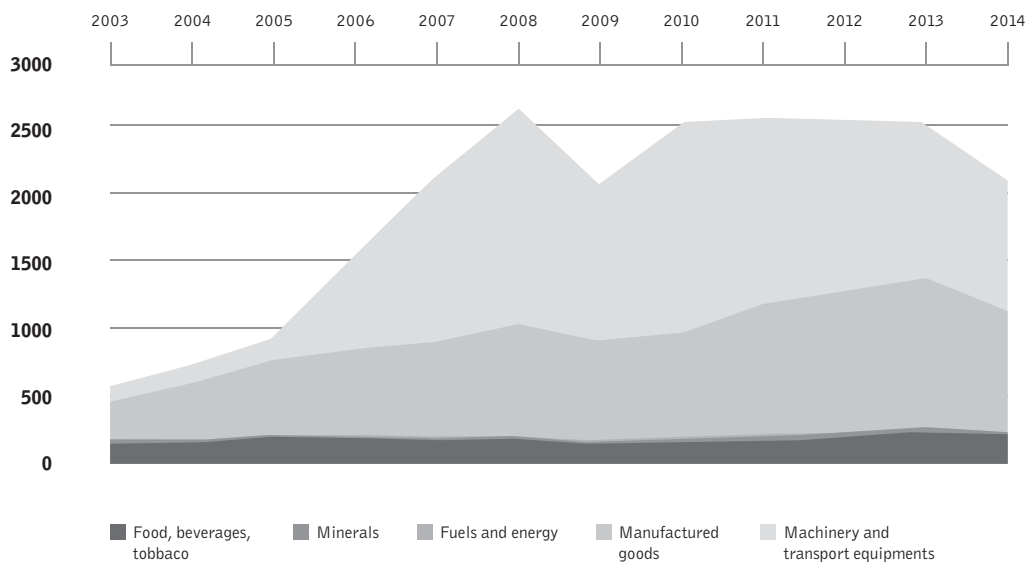
By 2014, however, Hungary had a significantly different outline of its Russia policy. By far the biggest component in this change was Viktor Orbán and his conservative followers giving up their reservations and objections against Russia. Policies and public appearances by senior officials and party leaders, approaching Russia both in economic terms and sometimes politically, demonstrate a radical shift in attitudes and preferences. All this, coupled with a highly controversial record of political developments in Hungary, leaves foreign observers at odds as to the nature, dynamics and trajectory of this bilateral relationship.

This chapter has two purposes. It attempts to provide an overview of bilateral economic ties including more recent developments. It also outlines an alternative to the Russian agenda in one of the most important linkages – energy. Finally, it endeavours to promote a better understanding of Hungary’s motivations in its Russia policy.

## 2. Just like in CEE – a limited relationship with a focus on foreign trade

For the Hungarian economy, the relevance of the Russian and Ukrainian markets – except energy – is relatively limited. In 2013, Russia’s and Ukraine’s shares of Hungary’s total exports were 3.11% and 2.39%, respectively. Even with these low proportions, these export destinations rank among Hungary’s largest export markets outside the EU. Exports in both cases grew steadily prior to the 2008 crisis, primarily in the machinery and manufactured industry segments. This is a strong indication of the increasing role of multinational companies in bilateral trade relations. Parallel to EU-Russia and EU-Ukraine economic trends, Hungarian exports practically stagnated after the crisis and fell in 2014–2015. As in some Western countries, euphoria about the post-Soviet markets was gone by 2013, and most economic groups have pursued a cautious strategy in the 2010s.

**Graph 1. Hungarian exports to Russia, mln EUR**

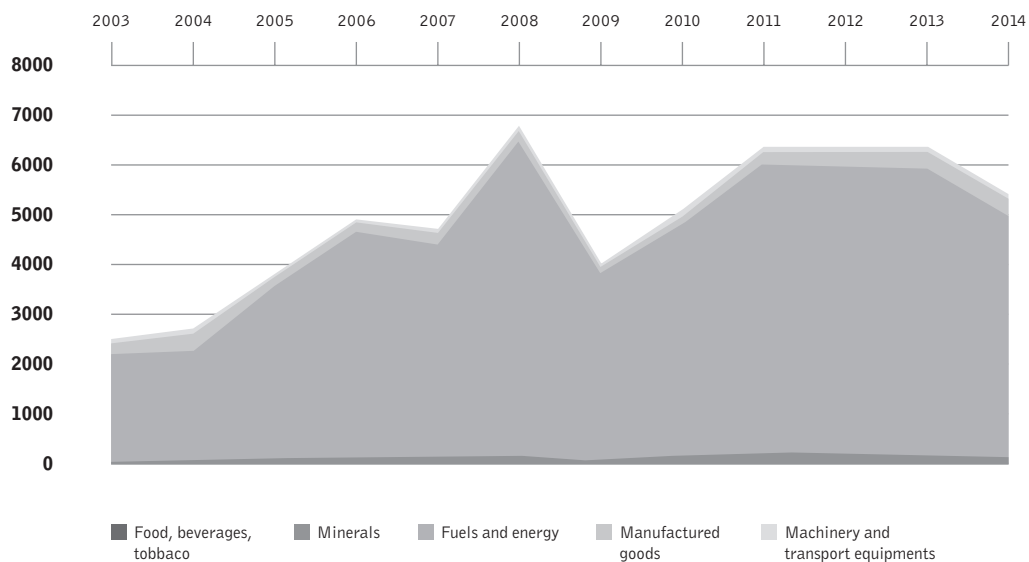


**Source:** Statat, Hungarian Statistical Office

Imports from Russia and Ukraine constituted 8.55% and 1.65% of the total in 2013, respectively. As statistical data demonstrate, energy constitutes an almost exclusive share of imports, especially in the case of Russia. It is worth noting that growth in energy imports can be attributed almost exclusively to the price effect: imported quantities increased only modestly prior to the 2008 economic crisis and have dropped substantially in the last couple of years.

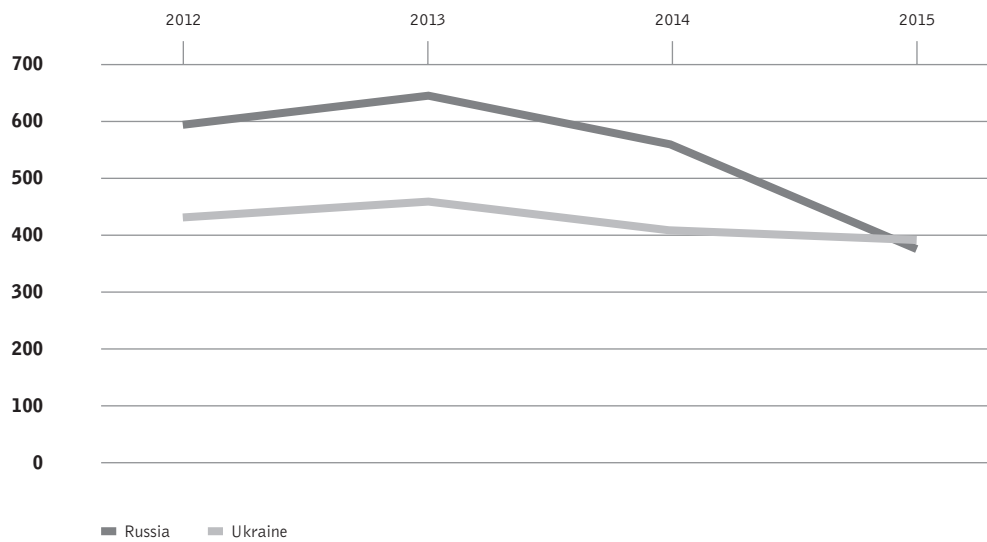
Exports have decreased significantly since hostilities began in early 2014. Hungarian exports to Russia dropped by double-digits both in 2014 and in the first quarter of 2015. There is no reliable information about the particular role of different kinds of sanctions, but exchange rate volatility and declining consumption in Ukraine and Russia have certainly had a major impact. In the case of Ukraine, Hungarian exports stalled much earlier and after 2008 never fully returned to their pre-crisis levels. Thus, the war and economic slowdown have had a slightly smaller statistical impact in the years since 2013.

**Graph 2. Hungarian imports from Russia, mln EUR**



Source: Stadat, Hungarian Statistical Office

**Graph 3. Hungarian exports to Russia and Ukraine in Q1s, mln EUR**



Source: Stadat, Hungarian Statistical Office

### 3. The vital, the visible and the minor – energy, trade and investment relations with Russia

As demonstrated above, the backbone of Hungary's bilateral relations both with Russia and Ukraine is trade. In the case of Russia, energy constitutes the dominant share of imports. Oil and oil products are traditionally imported from Russia by MOL, a domestic company in Hungarian private ownership (although the state also has a 24.7% share). Oil trading is relatively competitive, alternative supply routes are accessible, and no disputes have been reported except for some disturbances surrounding Ukrainian transit.

Natural gas imports present a bigger concern both in terms of supply and transit security, and in terms of prices. The 2009 Russian-Ukrainian gas dispute revealed Hungary's vulnerability and the limits of its network's resilience. High natural gas prices have also put considerable stress on social relations through utility prices in the last couple of years. The Orbán government purchased the wholesaler company holding the main long-term import contract (LTC) from E.ON in 2013. Thus, relations and negotiations about LTC conditions (price and pricing, take-over obligations, flexibilities, etc.) have become more politicised recently. Even if formally the LTC is held by state-owned company MVM, negotiations are held at the highest levels, often between Viktor Orbán and Vladimir Putin or Alexey Miller.

Nuclear issues are manifold – Russia is a key supplier of the fuel for the existing four Soviet-built VVER blocks at Paks, and Rosatom is a contractor in the current life-extension programme for these units. In parallel, the Orbán cabinet contracted two new blocks with Rosatom in 2014, for the construction of which Russia has also provided a EUR 10 billion credit line. The two new units are expected to be commissioned in 2025 and 2026 with roughly the same overall capacity as the four old blocks (2 à 1200 MW vs. 4 à 500 MW). The four old blocks will be phased out between 2032 and 2037.

Exports consist predominantly of manufactured goods and machinery. According to estimates, more than 65% of exports come from local subsidiaries of multinational companies. These outlets benchmark their exports according to their corporate strategy and market relations. Competitiveness is the dominant driver in these segments, and consequently bilateral relations and political decision-making have a limited role here. This is important, since the Hungarian government has an exclusively utilitarian approach to foreign policy, with Eastern export markets in its spotlight. Despite these ambitions, the government has little influence on this "multinational segment" of exports. Nonetheless, the decline in exports in some of these areas may have macroeconomic relevance. Although neither Audi nor Mercedes provide data about their exports, the Hungarian assembly lines supposedly have some relation to Russian and Ukrainian markets (these may even bypass Hungarian-Russian statistics if components are delivered to other EU countries for assembly).

There is not full clarity about the structure and nature of exports managed by domestic (Hungarian-owned) firms. Pharmaceutical companies (Richter and EGIS) are the most exposed to CIS markets, with almost half of their revenues coming from the region. In the case of Richter, 33% of sales were realised in Russia in 2013, with another 7% in Ukraine and 7% in the other CIS countries (*Richter Gedeon...*, 2014, p. 45). Agricultural exports are overrepresented in the public discourse, especially relative to their low statistical share (below 5% of the total). Nevertheless, certain influential groups and domestic tycoons have considerable interests in agricultural exports to Russia (e.g. Sándor Csányi).

In terms of investments, Hungary has relatively little exposure to Ukraine and Russia. The country's largest bank, OTP, placed CIS markets at the centre of its expansion strategy in the mid-2000s. Currently, Russia and Ukraine constitute the bank's third- and fourth-largest markets in terms of financial assets, respectively. This may be cause for headaches if the situation in the region worsens. For MOL, Russia had lost much of its significance by the end of the 2000s. Even though Russian assets have historically played a major role in forming the company's upstream portfolio, today MOL has

a more diversified pool of production. Certain other, smaller tycoons have relatively small investments in Russia, predominantly related to construction or other services. Thus, Hungary's overall exposure in investments is not at a critical level, perhaps with the limited exception of OTP.

#### 4. Business relations without businessmen – politics take the lead

It would be difficult to identify a "Russia lobby" in bilateral relations. This is partly due to the limited significance of the Russian economy for Hungary and the lack of transparency in economic ties. Nevertheless, the government currently appears to be a more determined advocate of strengthening business ties than any other major corporate group. In the latter's strategies, economic realities, conventional business risks and uncertainties about prospects have downgraded Russia relatively rapidly of late. OTP had heavy losses in both its Ukrainian and Russian portfolios, while Richter and other major exporters are following a "wait and see" policy. Thus, even though these corporate interests may function as a buffer against deteriorating bilateral relations, they definitely fall short of explaining the current good relations on the political level. Today, normal business and corporate relations do not play a leading role in Hungary's Russia policy; political leadership is undisputed.

Fidesz has made a political U-turn in its relations with Russia over the last couple of years. Viktor Orbán, a staunch critic of Russia for two decades, has turned into one of Moscow's most vocal defenders in the midst of its war in Eastern Ukraine. Orbán, who characterised Hungary as the "happiest barrack of Gazprom" in 2008, has concluded a huge nuclear deal with Rosatom and continues to pursue the most intensive negotiations with Gazprom since the fall of Communism. What is more, Orbán's supporters have followed him through this transformation: today, Fidesz is a Central European conservative party whose voters are the most pro-Russian in the Hungarian political landscape (*A magyarok többsége...*, 2015). Moreover, right-wing radical party Jobbik, Hungary's second-strongest party according to opinion polls, has criticised the government's pro-European stance and favours even more engagement with Moscow – a historically unprecedented and totally unconventional orientation for a radical right-wing party in Hungary.

The economic component in this strange transformation is difficult to grasp, but supposedly it played a major role. Economic considerations as such play a vital role in Fidesz's foreign policy. After his landslide electoral victory in 2014, Orbán delivered this new directive at the annual ambassadors' meeting with the rather blunt observation that "ideology-oriented foreign policy was invented by smart countries for foolish ones". Hungary's foreign missions were instructed to place greater emphasis on increasing Hungarian exports and investments, since "we live in an economic world" (*Orbán: Sunnyogással...*, 2014). Given widespread government corruption and the cabinet's almost exclusive affinity for economic considerations in foreign policy, Orbán's turn towards Russia must have had a strong economic justification. Energy is certainly a major issue in this regard. Both the 2014 Paks expansion agreement and Gazprom's parallel concessions in the Russian gas LTC signal that the two countries have strong *quid pro quo* relations. Corruption may play a role as well. In this regard, there is widespread speculation about the MET gas trading company's relations both to Gazprom and perhaps even to Viktor Orbán personally or to certain agricultural export channels (*A legtöbb pénzt...*, 2015; *További Magyar...*, 2014).

Given this murky background, it is difficult to measure the magnitude of bilateral relations and their future. At this moment, it very much seems that Hungarian-Russian relations do not constitute a "love affair", but rather a business relationship on the political level. Furthermore, much of the potential benefits seem to have already been collected by the Hungarian side. In this regard, there is a certain chance that if Moscow does not offer more, Fidesz will rebalance its foreign policy and give in to suspected US and Western pressure. These rebalancing attempts were relatively obvious during the first half of 2015 after Putin's visit to Budapest in February. Nonetheless, many issues in bilateral

relations remain unresolved, paving the way for some “hard talk” between the sides in the foreseeable future. Politically motivated business relations are always shaky, and this may also be the case between Hungary and Russia.

## 5. More noise than damage from sanctions

It is difficult to measure the impacts of sanctions on Hungarian-Russian relations. It is practically impossible to separate their implications from those of Russia’s declining economic trajectory and worsening trade and investment ties. The direct impacts are negligible: Hungary does not have arms, oil or gas drilling machinery exports to Russia, and Russian financial organisations and companies do not take out loans in Hungary. Russian sanctions on agricultural exports may have a bigger direct effect, however: according to the government, Hungarian producers are losing EUR 80 million annually due to countersanctions (*Nyolcvanmillió euró...*, 2014). This constitutes roughly 0.08% of Hungary’s GDP, and Budapest has requested compensation from the EU.

Indirect effects and implications from the Russian economic downturn may be more significant. Given the limited scope of foreign trade, its overall impact could hardly exceed 0.3% of Hungary’s GDP, and is presumably much less.<sup>63</sup> Exporters are reportedly mainly suffering from the effects of the exchange rate: pharmaceutical firms, car producers, and agricultural exporters (in the non-sanctioned segments) have been affected most. For OTP, whose Russian branches focused on rouble credits in the retail sector, the increase in the CBR’s interest rates may cause difficulties. However, since the Russian economy is showing early signs of recovery from the initial panic, exchange rate volatility and interest rates have been decreasing, and some normalisation is expected during 2015.

Except for some agricultural producers, companies have not asked for help from the government, which has harshly criticised the sanctions; Viktor Orbán characterised them as “shooting ourselves in the foot” (*Orbán: Lábom...*, 2014). There is not too much differentiation between Western sanctions against Russia and Russian countersanctions. According to the cabinet, sanctions are harmful for European economies and are not bringing about results, and the conflict can only be resolved through negotiations. Nevertheless, Orbán has not threatened to veto EU or NATO decisions, and his critical remarks have remained only rhetorical thus far.

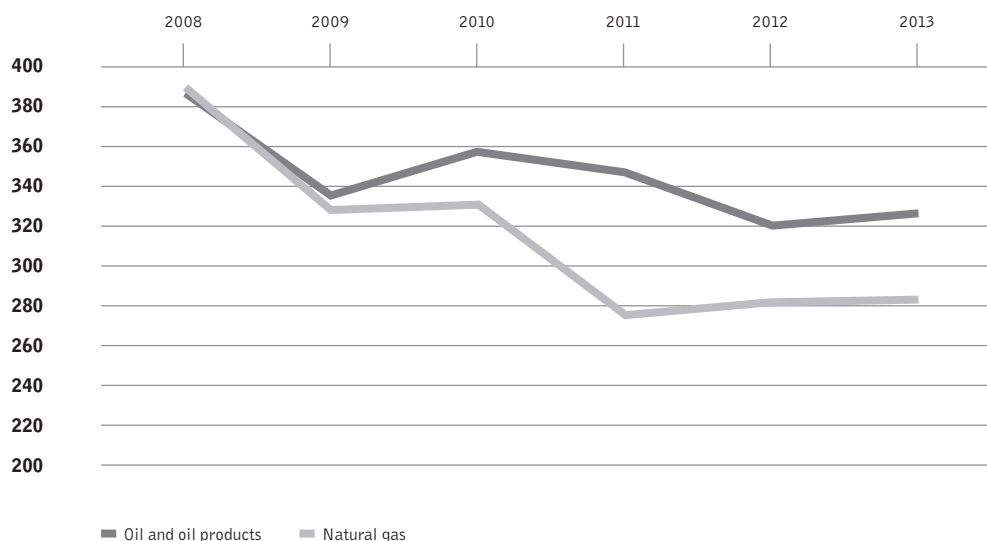
## 6. At centre stage again: Russian energy

Hungary’s energy dependence on Russia in the past decade was characterised by controversial trends. In terms of volumes, imports have been decreasing rather rapidly, mainly due to a sharp drop in domestic gas consumption.<sup>64</sup> At the same time, however, Hungary pays roughly the same import bill for these decreased imports in value terms due to the rise in oil prices. As a result, it is fair to say that despite remarkable improvements in Hungarian energy security since the 2009 gas crisis, the domestic perception of Russian dependence has not changed too much. For many policy-makers and political actors, Russia remains the dominant supplier and Moscow has a strong mandate for negotiations on most energy-related questions.

<sup>63</sup> There are no official or public statistics on this, and this figure is an estimate collected by the author from macroeconomic analysts working with Hungarian data on a continuous basis.

<sup>64</sup> Gas consumption fell from its peak of over 13 bcm in 2006 to below 8 bcm in 2014.

**Graph 4. Hungarian gas and oil imports**



**Source:** MAVIR

It is important to note that the energy supply situation has improved in a single major respect since the January 2009 Russian-Ukrainian gas price debate: accessibility to Western European markets has been greatly enhanced. This includes better interconnectivity with Western European hubs and within the region, the emergence of liquid hubs throughout the continent, and their impacts on contractual relations. In the Hungarian case, thanks to the pipelines with Baumgarten and the Slovak-Hungarian interconnector, the country complies with the N-1 rule and possesses sufficient border capacity to import gas from other sources if the Ukrainian pipeline is disrupted. Most of these achievements are lasting and point towards greater cohesion and consistency between Western and Central European markets. Coupled with some less visible trends, such as an emerging single electricity market and sharply decreasing domestic gas consumption, the context of Russian supply dominance has been changing. Direct Russian gas imports have practically halved, mainly due to decreased demand, but also due to more imports from Western hubs.

Despite all these policy and market improvements, Budapest and Moscow continue to engage in separate and non-transparent energy talks. Independently from the diminished relevance of Russian long-term gas contracts and the more articulated European stance on competition issues, Russia still has the potential to shape regional energy relations and probably to bias European policies on a broader range of issues.

The reasons are manifold. First, Russian energy remains the cheapest source for Hungary. Western and maritime imports are increasingly accessible, but not competitive with Russian oil or natural gas. Local hubs (Baumgarten) offer lower prices, but their liquidity is low. Imports from Western European hubs (primarily TTF in the Netherlands) lose their price advantage due to long transit routes across the continent. LNG imports have been facilitated in some CEE states (Poland, Lithuania), but there is a premium: LNG costs more than Russian gas, so it is highly unlikely that Hungary would opt for such an investment. What is more, there is no credible plan to change this situation. Unlike the period between 2008 and 2012, when the V4 countries had a credible agenda and Hungary was hoping for cheaper LNG, Azeri imports through Nabucco-West and new patterns of regional trade, today no major new developments are on the horizon. The European and regional agenda has lost much of its

attractiveness. The policy-makers are enjoying the benefits of these achievements, but it is very tempting to look to Moscow for more rather than to Brussels.

Second, the transition from bilateral LTCs to hub-based, high-frequency gas markets is a very long one. Since 2009, these contractual relations have been renegotiated incessantly. Even if Gazprom has to make concessions, this bargaining process also opens up opportunities for Moscow to differentiate between national partners. Even if there is a chance that these practices will disappear over time, the scope for bilateral bargaining is currently much broader than a decade ago. It is not always about price. Often take-over obligations (TOPs) and flexibility clauses are at least as important as prices or pricing. It is too early to write off gas contracts as a potential means for influencing national policies inside the EU and in Hungary in particular.

Nevertheless, the most important change in Hungary is the shift from considerations of energy security towards those of social affordability. Oil and gas prices have multiplied during the last decade and have remained at an unprecedentedly high level since 2010. This is not only a current account problem, but also sets the issue of energy prices higher on the domestic agenda. Despite all efforts to keep consumer prices for natural gas and electricity at lower levels, according to Eurostat the share of Visegrad utility costs ranged from 7.3% (Hungary, after introducing a ban on gas and electricity price increases for households in 2010) to 11.3% (Slovakia) of final household consumption in 2012 (*Eurostat – Annual national accounts*). This is almost double the proportions in Western Europe. Prior to the crisis, more than 70% of Hungarian households used natural gas as the primary fuel for space heating. Not surprisingly, utility prices are among the top issues of concern by the population. All of these social affordability considerations have resulted in more active political involvement on policy issues, a major, politically driven regulatory squeeze on the profitability of the utility sector, and renationalisation at the corporate level.

Fidesz introduced a moratorium on raising gas and electricity prices right after its electoral victory in 2010 (*DG Energy...*, 2014). This proved painful for corporate stakeholders especially in the gas segment, since import price levels have increased by more than 25% in subsequent years. The regulator has kept the different cost items in line with the moratorium. In 2013, Fidesz launched a major utility rate cut campaign, further decreasing consumer prices by more than 25% in the following year and a half. This was Orbán's silver bullet in his 2014 electoral campaign, a cornerstone of his second landslide electoral victory. A populist taboo has thus been established with respect to utility prices, especially as far as gas and electricity are concerned. At the same time, significant losses have emerged in the gas sector value chain, which continue to cause longstanding financial tensions. EU regulations leave little room for subsidies, thus threatening the long-term financial sustainability of Hungary's current price regime.<sup>65</sup>

Unlike energy security, which is more EU-related, social affordability is still perceived by most of the policy stakeholders as a bilateral issue with the dominant supplier. This is a major window of opportunity for external suppliers, namely Russia. Russian export price concessions constitute a major tool to help to sustain these populist energy price policies. Gazprom provided a significant set of concessions in the LTC right after the renationalisation of the wholesaler company between October 2013 and March 2014. Reportedly, both the price formula and price levels were changed, and Gazprom also decreased TOP levels (*Gazprom eyes new Hungarian deal*, 2014, p. 6). Without these concessions, the government's utility rate cut policy would hardly be sustainable even in the medium run. Paradoxically, in the case of energy price populism, the EU is more of an enemy and Russia is a potential ally for many decision-makers.

Not surprisingly, major international companies such as E.ON, GDF and RWE have been leaving the sector. The state-owned Electricity Works (MVM) and more recently the National Public Utility Company have taken over their positions. MVM purchased the wholesaler and the gas storage companies from E.ON in 2013, and foreign firms have exited from the retail sector more recently. Consequently,

<sup>65</sup> The EC has already launched an investigation into certain discriminatory practices related to favourable electricity and gas pricing for households (Kapitulál..., 2015).



gas negotiations with Russia have again become increasingly politicised, and Viktor Orbán is personally engaged on this issue. Today, Hungary has an unprofitable gas sector, where price increases are not tolerated politically and the state is forced to subsidise the sector in a manner that is hidden from the European Commission.

The nuclear deal on the Paks expansion further increases uncertainty with respect to Hungarian-Russian energy relations. The contract came out of the blue, with no serious discussions having taken place prior to the January 2014 Orbán-Putin agreement. Notwithstanding, the replacement of the four existing VVER blocks at Paks, which deliver almost half of Hungary's electricity, constitutes one of the greatest challenges for Hungarian energy policy. This contract offers more questions than answers, however: the new blocks would be commissioned as early as the mid-2020s; the timing of the signing just three months before the elections was highly risky for Fidesz; and almost all regulatory issues, especially those related to the EU, were neglected, leaving these questions unanswered. The project also lacks quasi-consensual political support, and in its current form also economic and policy justification. It will certainly cause major tensions with the European Commission's Directorate General for Competition, and given the EUR 10 billion Russian credit line (approximately 10% of Hungary's GDP), the contracts constitute by far the single largest budget item in the bilateral relationship.

## 7. Waiting for Godot – pipeline projects and Hungary

Hungary inherited an unfavourable gas supply situation from the 1990s. Gas imports constituted a very high, almost 35% share of Total Primary Energy Supply (TPES), and almost all natural gas came exclusively from Russia and through Ukraine. The country was a dead end for suppliers, as no major transit quantities crossed Hungary. The network was able to weather the 2009 gas crisis only due to its relatively large reserves. All this led to a relatively early notion of insecurity and elaboration of interconnectivity and pipeline projects. These included the New European Transmission System (NETS) project proposed by MOL, an attempt to integrate regional networks and build new interconnectors in the mid-2000s, and the Nabucco project, designed to bring Middle Eastern and Caspian gas to the region. Russia joined this contest with the South Stream project already in 2006, and its entry was hailed by Hungary's incumbent Socialist-liberal government.

Despite its harsh criticism of South Stream in opposition, Fidesz had changed sides by 2013 and was a forceful advocate of the Russian pipeline. The fiasco with Nabucco-West in 2012 further accelerated this process, and left the Russian project as the only one on the negotiating table. After the cancellation of South Stream in early 2015, Hungary elaborated – allegedly not independently of behind-the-scenes Russian suggestions – the Tesla pipeline from Greece to Hungary through Macedonia and Serbia. This project is merely another addition to the broad set of pipeline options in the SEE region, including Slovak-led Eastring and EU-proposed Gas Ring. These are competitive proposals, and Budapest would like to remain a policy shaper on this issue. The Hungarian government is keen to bring transit to the country and fears being left out if any of these pipelines are built. It thus keeps the Russian connection alive, because Moscow is still perceived as a major policy-maker in these pipeline projects.

Russian pipeline projects remain attractive predominantly as a bargaining chip in gas supply talks. They also enhance contractual diversity, potentially providing access to other importers' contracted gas volumes. Furthermore, Hungarian policy-makers are hoping for better utilisation of their idle storage capacities (total storage is above 6 bcm, more than twice the average domestic need for annual seasonal balancing). Supply security and managing Ukrainian transit risks constitute a common interest with Gazprom, while investments as such are of particular interest for the cabinet. Revenues from South Stream transit fees would have comprised 0.2% of GDP (Lecture by Csaba Kiss, 2014), a considerable amount, albeit much less than in the SEE countries (in Bulgaria it would have been around 2%).

Although Hungarian pipeline policies are often characterised as Russia-friendly, this assessment is not fully justified. As a result of so many disappointments, the record of pipeline- and EU interconnectivity projects is relatively limited in Budapest. In view of the many different and competitive, but unrealised proposals, including those from Russia, most domestic stakeholders approach any project with caution and circumspection. Russia is still perceived as a key policy-maker in this respect, but its credibility in this area is rather limited as there is currently no major EU project on the table.

## 8. A reluctant member – attitudes towards European energy policies

In general, Hungary approaches EU energy policies with a CEE mind-set and some national peculiarities. Interests are concentrated around energy security and social affordability issues, while competitiveness and climate change take the back seat among the country's priorities. Accordingly, price and transit issues are strongly represented, while liberalisation, renewables and energy efficiency policies are almost completely absent from the national agenda. The country traditionally coordinates its actions closely with its Visegrad partners, although Budapest has started to form its own agenda on particular issues. The extensive use of administrative utility pricing and its Russia-friendly stance cause the most tension with the European Commission. In this latter regard, the Paks expansion and the issue of reverse gas flows to Ukraine are of particular interest.<sup>66</sup>

Hungary had practically completed its gas interconnectivity and security programme by 2013, much earlier than its neighbours. Interconnectors with all neighbouring states except Slovenia were constructed. Despite all the controversies, Hungary was the first to raise the issue of Ukrainian reverse flows at the corporate level as early as 2012. As far as EU security policies are concerned, Hungary's performance is rather good, despite all the political disturbances. Indeed, it is Budapest that has shown some dissatisfaction with the European Commission's downsizing of regional security efforts. According to European gas stress tests, Hungary is in the "secure" category, a classification which sounds very doubtful among Hungarian policy-makers. Attitudes were also sceptical of the European Commission's regulatory behaviour in the EU-Russia conflict around South Stream, as many policy-makers found the DG Energy's approach too rigid and inflexible. Like so many other potential transit states, Hungary would have preferred a compromise between Brussels and Moscow.

## 9. The Energy Union and Orbán – an uneasy welcome

Viktor Orbán has given conflicting assessments of the published Energy Union concept. In certain interviews, he has praised it, while on other occasions he has characterised it as unacceptable, contending that it further limits national sovereignty over energy policies (*Orbán says...*, 2015; *Orbán at Visegrad 4...*, 2015). Obviously, the initiative is too complex and at too early a stage to provide a comprehensive assessment. Most regulators and corporate actors have been waiting for the final legal drafts. In the light of Hungary's past reactions and current energy policy record, it may be reasonable to expect a calm and highly restrained welcome coupled with loud criticism by Viktor Orbán personally.

The Energy Union concept refers to a broad range of potential measures, and consequently opens up room for compromises between member states. Like many other CEE states, Hungary supports diversification and infrastructure development projects from the common budget, since the country is a net beneficiary of these transfers. The government has a mixed attitude towards proposals related

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<sup>66</sup> Hungary suspended reverse flows temporarily in September 2014.

to climate change: primarily because of the Paks expansion project, it supports the increased carbon reduction target (40% by 2030), while it opposes the 27% renewable target. The most controversy may come from efforts to increase transparency, stricter implementation of measures under the third package, the new responsibilities of the regulator ACER, and new legislation concerning nuclear fuels and projects. All these measures would further limit the role of national jurisdiction and delegate competencies to common institutions. Hungary certainly will strive to keep its sovereignty untouched, opposing most of these new potential limitations.

## 10. Shipping and cutting – the case of reverse gas flows to Ukraine

Hungary played a positive role in establishing the physical and regulatory framework for reverse gas flows to Ukraine. Unlike Slovakia and like Poland, the Hungarian pipeline operator (FGSZ) initially had a dedicated, empty pipeline between the two countries. This capacity induced FGSZ to start reverse supplies without formally requesting Gazprom's approval or investing additional funds into the network. Since FGSZ had long been advocating for Ukrainian reverse flow, the Hungarian Regulatory Office established an exit point and allowed its capacity to be auctioned in spring 2013, just after the Polish reverse supplies started. The utilisation rate was relatively low, far below the technical limits. Constraints mainly came from Ukrainian national oil and gas company Naftohaz, and involved cheaper access to Russian or Slovak supplies, or a lack of funds in the Ukrainian budget. More recently, in June 2015, FGSZ and Naftohaz agreed to upgrade the interconnector's regulatory standards in order to comply with EU requirements. This is the first action of its kind among CEE-Ukraine border capacities; it is strongly opposed by Gazprom and has been welcomed by the Energy Community.

In September 2014, Budapest temporarily stopped reverse flows citing technical reasons, and increased import demand for Hungarian storage. From a legal point of view, FGSZ had the right to do this, as reverse flows were contractually interruptible. Technical data did not justify this action, however, as ample free capacity had been present in the successive period. It is more likely that Alexey Miller's meeting with Viktor Orbán just three days prior to this statement played a role in the gas export suspension. Gazprom publicly condemned the existing system of reverse flows to Ukraine and contracted Hungarian storage capacity for the winter period. Supposedly, the move had been prompted by the Hungarian side requesting Gazprom to fill the storage capacity, since MVM lacked the necessary funds. Reverse flows were resumed after Vladimir Putin's visit in February 2015. This short episode aptly demonstrated the duality of the issue: FGSZ, owned by MOL, is financially interested and strongly advocates reverse flows, while the government maintains hidden control and uses it according to its volatile preferences.

## 11. Hungary at a crossroads? – a rational or “Russian all” energy policy

From the description above, it is obvious that Hungarian-Russian relations are not balanced and that Hungary is on the vulnerable end of the string. In the trade balance, the Russian portion is much larger and energy carriers or energy-related suppliers constitute a massive portion of the inflow of goods. Hungary thus depends on Russia to a great deal in terms of its energy production. The current official energy strategy thus states very clearly that Russia is Hungary's most important partner in this connection, but also states that this one-sided dependence should be eased (*National Energy Strategy 2030*, 2012, p. 27).

At this point, we need to understand that everything that would make Hungary less dependent on Russian resources and less vulnerable to Russian political turns has nothing to do with Russia. The measures or policies or technologies that would make Hungary less reliant, more independent and self-sufficient, flexible and stronger in the context of energy – i.e. the things that would strengthen Hungary’s bargaining position – are independent of any Russian relations. Energy efficiency and renewable technology after all are not the strongest part of the Russian economy. To be clear, the Hungarian government would not need the consent of the Russian president to launch a massive energy efficiency programme, or to strengthen the weak renewable feed-in tariff. The postponement of or failure to implement sustainable energy measures during the last decade has thus helped to create a situation in which Hungarian energy policy is much more defenceless against the Russian energy industry than it otherwise would have been. And we can add that the quality of the energy policy and governmental actions in this area has worsened significantly over the past five years.

This is the reason why the remainder of this chapter will focus less on Russian gas deals, the various potential routes for pipelines and the details of the new Russia-financed nuclear power plant, and much more on what has distorted the Hungarian energy market and on actions not taken in the past. These actions would have been the fundamentals and the bases of Hungarian energy security, and would have resulted in further benefits as well, but the environment and the economic reality are not really among the current government’s concerns. (To be fair, however, the environment has never been a concern of any Hungarian government.) These measures are the relevant, effective, expected and agreed actions of an EU member state. More significantly, however, we must underscore that these measures – enhancing efficiency and the uptake of renewable technologies – would have been rational actions in Hungary not because of its commitments to the EU, but because of Hungary’s own interest.

Why are experts convinced that these are rational actions? To answer this question, we need to re-examine the characteristics of Hungary’s energy market as well as recent developments in energy policy. Based on this, we can make an informed judgment about the situation and the Hungarian government’s preparedness and ability to cope with it.

Several facts, major trends and developments are worth repeating as bullet points:

- limited conventional energy sources and reserves;
- major imports from Russia in oil (85%), natural gas (79%) and nuclear fuel (100%) in 2012 (*Member States’ Energy Dependence...*, 2013);
  - in terms of oil, the Hungarian import structure is among the most concentrated in the EU (*Member States’ Energy Dependence...*, 2013);
  - Hungary had one of the highest shares of gas in the energy mix among EU countries in 2010; the household sector is very dependent on natural gas (70% of household use this source of energy one way or another);
- solid fuel/lignite constitutes only a limited share of the energy supply (11%), although with respect to this source Hungary is in a relatively strong position in terms of dependency compared to the EU average;
- Hungary’s storage capacity for natural gas is enormous compared to national consumption;
- Hungary’s geopolitical position is very beneficial for long-term energy flows through the country;
- Hungary has a huge and unexploited energy efficiency potential<sup>67</sup> – in the household sector alone, the economic energy savings potential is 15% of the country’s total primary energy supply;
- Hungary has a huge and unexploited renewable potential; in 2013, the share of renewables was around 10% of gross final energy consumption (*Share of renewables...*, 2015) and the target for 2020 is 14.61%; both Hungary’s current share and its official target are in the lower third among EU countries;

<sup>67</sup> Everything you want to know about Hungary’s energy efficiency potential is at Energiaklub’s NegaJoule website: <http://negajoule.eu/en>.

- Hungary has new cross-border infrastructure with EU member states and other neighbouring countries (for both natural gas and electricity).

The European Commission's last report on European energy dependence (*Member States' Energy Dependence...*, 2013) concludes that Hungary has total energy import dependence in line with the EU average, but its high energy intensity contributes to its high energy trade deficit. It is important to note that the high overall energy intensity originates from the transport sector and more importantly the household sector. Increasing the country's current low level of renewable energy production while improving energy efficiency would reduce Hungary's energy trade deficit. Furthermore, given the very high proportion of Russian gas in its energy mix, alternative, potentially cheaper (in light of the recent fall in global natural gas prices) gas supplies could also reduce the energy trade deficit.

We can thus conclude that one of the eminent aims of Hungarian foreign policy and energy policy should have been to decrease this dependence. The solution to this problem is not rocket science. The above-mentioned report and many other documents, as well as Hungary's energy strategy and international commitments, all include and refer to increasing the use of local resources through: a) energy efficiency, b) renewables, and c) diversification of natural gas routes.

What is really striking here is that the last of these options usually receives much more attention from decision-makers, the media and experts. Diversification of gas pipelines – as recent examples show – is a risky business. Governments, state-owned and private companies, institutions and diplomatic circles can spend years negotiating a deal and suddenly a new development or an announcement by Gazprom or President Putin can scuttle the whole plan.

By contrast, developing domestic resources, lowering domestic demand through smart measures and innovative financing options, and systematically building up the capacity of new technologies as well the confidence and trust of investors – this strategy is entirely in the hands of national governments. It requires persistence, commitment and a certain amount of creativity – and the fruits of these efforts admittedly cannot be harvested in a fortnight – but this strategy certainly has a greater likelihood of effectively influencing the national energy market and the various players in this area than the foreign policy manoeuvres of a small European country trying to influence Middle Eastern energy moguls, the Russian government and/or Russian energy companies, or of having any impact on global energy prices as such.

With this in mind, how can we characterise the Orbán government's energy policy?

One major effort is obvious and has been well communicated: providing cheap energy to the people. The favourable deals with Putin on natural gas and construction of a new nuclear power plant are said to be the underlying fundamentals of this goal, but most energy policy experts would consider this to be rather misleading propaganda.

Let us examine what has happened and what has not happened in the name of this tunnel-vision policy goal.

## 12. Household energy bills cut

This is a commonly used weapon in the post-Soviet bloc, and Orbán played this card well, winning the general elections again in 2014. As indicated above, cutting household utility prices is a misleading measure even if we assume that there had initially been some room such reductions. The policy started at the end of 2012, and by now it should be obvious that this has caused market distortions in the form of cross-financing between the household and industrial sectors. Recently, new announcements have been made, and a further decrease is anticipated. An additional government-imposed decrease in the household sector will increase cross-financing and thus raise energy costs for industry, worsening Hungary's competitiveness.

This is also a mentally, socially and politically problematic issue, as consumers are led to believe that the prime minister can set energy prices at will. There is also an institutional problem here: the integrity and accountability of the Hungarian administration and in particular the Hungarian energy regulator which had to prepare and implement the new rate system. This market distortion created an unpredictable business environment for international energy companies (E.ON, RWE, EDF, etc.), which induced them to halt operations and even to relinquish capital investments in order to escape from the country. All told, this sole measure will have a very long-lasting negative impact not only on energy policy, but also on the trust of major investors and multinational companies. It will take a tremendous effort, political marketing and a strong course of action to regain this trust.

### 13. A new Russian nuclear power plant

Following the manipulation of energy prices, the construction of a new nuclear power plant was introduced as a cornerstone of cheap energy and energy security. The new power plant, if ultimately constructed and brought online, will generate electricity at a much higher price than the European and Hungarian electricity systems produce today or would otherwise produce in the coming decades (Felsmann, 2015), thus making the entire Hungarian energy system more costly and raising prices for end users. Alternately, if the capital costs of the plant are not included in electricity prices, as the Hungarian prime minister suggested while explaining the origin of cheap electricity, then these costs will fall to taxpayers.

In terms of energy security, it is very difficult to verify that tying Hungary to Russia with an additional string will make the country's energy situation more resilient. In fact, just the opposite is true.

The Russian-Hungarian nuclear deal is at least as important as the natural gas business between the two countries, if not more so, and – although this has been denied – it could be the case that the two agreements go hand in hand. The new nuclear deal further ties Hungary to the Russian sphere of influence in multiple ways. The plant is to be financed, constructed and supplied with fuel<sup>68</sup> by the Russians, and they will also treat the spent fuel.

Since the announcement of this deal, there has been no answer to the obvious question of why this agreement was so urgent and signed several months before the elections. Politically, it was a very risky move for Viktor Orbán, since any major business with Russia leaves a bad taste in the mouths of Fidesz supporters. The list of questions is much longer than this, however, and there have been no reasonable answers on practically any of the basic issues, and no responses or compelling arguments have been offered in respect of any of the concerns raised.

We now know that the price per kilowatt-hour of electricity from this plant will be much higher than the government has communicated thus far. We also know that the European Commission will conduct a thorough inspection of whether or not this deal and the financial component of the construction involve illegal state aid. This will obviously impact the Russians, for whom the construction of a nuclear power plant within the borders of the EU is a prestigious project. The Russian state will finance it, build it, and supply the fuel for it at least initially. Although Euratom's institutions have significantly shortened the term of the original contract on the supply of fuel, the spent fuel will also be taken care of by the Russian nuclear industry. The Russians will thus control the whole cycle.

In addition to all the above-mentioned problems connected with the construction of Paks II, the project also constitutes a huge obstacle to the future development of sustainable energy in Hungary. Given the country's size and GDP, an investment of this magnitude into a single project will have the practical effect of blocking all the capital flow into other areas of energy production.

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<sup>68</sup> The Euratom Supply Agency has reduced the guaranteed and contracted period during which Russian fuel producers will be the principal suppliers, however (Euratom signs off..., 2015).

## 14. Energy efficiency first

As has already been stated, energy efficiency is the first and most important aspect of energy policy for many reasons. It makes the whole economy less energy-intensive, less dependent on outside resources and more competitive, and it improves housing conditions, which results in fewer health issues connected to poor living conditions. Investments in energy efficiency would create a huge number of jobs all over the country, and would require people with more education and training. And the list goes on with beneficial environmental and budgetary impacts, as well as a positive, long-term effect on the trade balance.

It seems that Fidesz understood this in the run-up to the elections, and a substantial portion of the campaign was devoted to new energy efficiency schemes and government-supported financial programmes. Since then, however, practically nothing has happened in this area, and the utility rate cuts have halted even these investments in the household sector, which otherwise probably would have been made even without any governmental support scheme. There were no effective information campaigns, awareness-raising programmes or financial incentives, and even the building code and regulations of renovations were not strengthened to a reasonable level, let alone to an optimal level. These were basically a series of non-actions that caused a significant backlash in the construction industry, already severely impacted by the economic crisis.

The promises and the small amount of short-lived financial support provided by the government over the last five years have probably resulted in more damage than benefit. They created a very hectic situation in the market, forcing industry to react very quickly to these small, campaign-like support schemes. They had to hire and then lay off workers from among the ranks of those who had remained in the country after the outbreak of the crisis. At the same time, many households postponed their investments while waiting for new support schemes that never materialised.

Altogether, the Hungarian government has acted as if it would like to sabotage or block any major progress in this area. They must know that energy efficiency is slowly creeping into all spheres of energy consumption, and that it would be much better to direct this development than to suddenly be confronted by a decline in demand that would render unnecessary much of the investment in the natural gas network, for example. They must know that in the household sector alone such projects would save 15% of the country's total primary energy demand, which is actually equivalent to the output of the existing Paks Nuclear Power Plant.

## 15. Renewables – “the sun never shines at night”

This is a classic quotation from László L. Simon, previous head of the parliament's cultural committee. “What are we going to do if the wind doesn't blow and the sun is not shining? We still need electricity.” (*Nem lehet csak naperőmű...*, 2014)

This is the level of understanding of energy policy among MPs and even the government's top decision-makers. They must be aware, however, that surveys show the Hungarian public have a much better understanding of this issue and support the development of renewable energy sources – they would laugh at such a statement.

Hungary has huge and unexploited potential for wind, solar, geothermal and biomass energy. According to Energiaklub's latest modelling effort (Sáfián, 2015), the country could function very well in 2030 without a new nuclear power plant but with cogeneration partly based on biomass, 2,800 MW of wind capacity and 1,400 MW of solar. This would produce 27% of Hungary's electricity consumption in 2030. This scenario necessitates many new investments and infrastructure upgrades, but these need not involve that much state financing if better legislation and governance are in place. It would also provide many more jobs in a far wider geographic area than is envisaged in the official energy plan, which contains basically a single project: Paks II.



The government's attitude is obviously much more hostile towards this area of policy and investment. The new Fidesz government's first move in 2010 was to withdraw the announcement of "winners" in the 440 MW wind tendering, which was in the final stage at that point. No explanation or reason was given. Subsequently, the government announced that it would reshape the feed-in tariff system, but then the process was suddenly halted right after it had begun and has never been resumed. The government is keeping the entire industry in this extra-legal position. Occasionally, there is a new episode in the form of an unprecedented levy on solar installations, as was the case in early 2015.

## 16. Conclusions: a big no to sustainability

From the above, we can conclude that Orbán's government does not want to see sustainable energy compete with nuclear power, and at the same time wishes to buy votes with the promise of ever-decreasing energy prices. Most of the energy business is characterised by non-transparency and state secrecy (e.g. MET and Paks II), which implies a strong possibility of corruption. The Hungarian government does not want to see wind turbines or solar panels on the roofs of residential houses throughout the country, and has not made it advantageous to farmers to transform their residual agricultural materials into biogas. The government does not want people and industry to save energy, even though this is the cheapest energy source for the coming decades.

At the same time, for unknown reasons, the Hungarian government wants to build a taxpayer-funded nuclear power plant that would totally distort the Hungarian energy market and tie the country to Russia in additional ways. This energy policy is not based on evidence, research and rational reasoning. Rather, it is based on unrealistic assumptions and old, retrograde reflexes from Soviet times: the state needs to build power plants and to own the energy industry in order to control energy prices and provide cheap energy to the people at all costs. And the Russian state and state-owned companies are good at serving this type of energy policy; this is the policy they understand and can work with.

As has already been stated, energy efficiency and renewable energy seemingly do not have anything to do with Russia, but the fact that Hungary is not building on these diverse and innovative technologies determines the direction of energy development and ties the country even more tightly to an old-fashioned empire that wishes to keep the "conquered" nations in a vulnerable position. The main problem is that the Hungarian government is assisting in this effort.



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