CENTER FOR THE STUDY OF DEMOCRACY

TACKLING THE KREMLIN PLAYBOOK IN ITALY: ENERGY SECURITY RISKS AND ECONOMIC DECOUPLING

Policy Brief No.112, June 2022

The Russian invasion of Ukraine has put European energy and climate security through its most difficult test so far. The energy crisis, which began well before the war, has been continuously used by Russia as a way to pressure the European Union, through some of its members, to weaken the common European resolve in support of Ukraine and to water down sanctions against the Kremlin. The ensuing spike in energy prices, aggravated by the slow pace of energy transition and the excessive overreliance on Russian fossil fuel imports, has started to gnaw at popular and political support for further sanctions, and has demonstrated the need for a new European energy and climate security strategy based on new governance mechanisms.

Italy has emerged as one of the most vulnerable countries in terms of security of supply risks and geopolitical exposure to Russia.[1] Together with Germany, Italy has accounted for the bulk of EU's growing dependence on Russian gas imports over the decade preceding the war in Ukraine (see Figure 1).

The share of Russian gas in Italyian imports has increased from 29% in 2009 to 47% by 2019. In addition, leading Italian oil and gas companies have been engaged in some of Russia's strategic energy infrastructure projects that have indirectly enabled the war in Ukraine. Italy's ENI sourced 36% of its total gas supplies in 2020 from Russia. The company also has a 50% stake in the BlueStream pipeline, a key part of Russia's strategy to reduce Ukraine's geoeconomic bargaining power by circumventing Ukrainian gas transit.

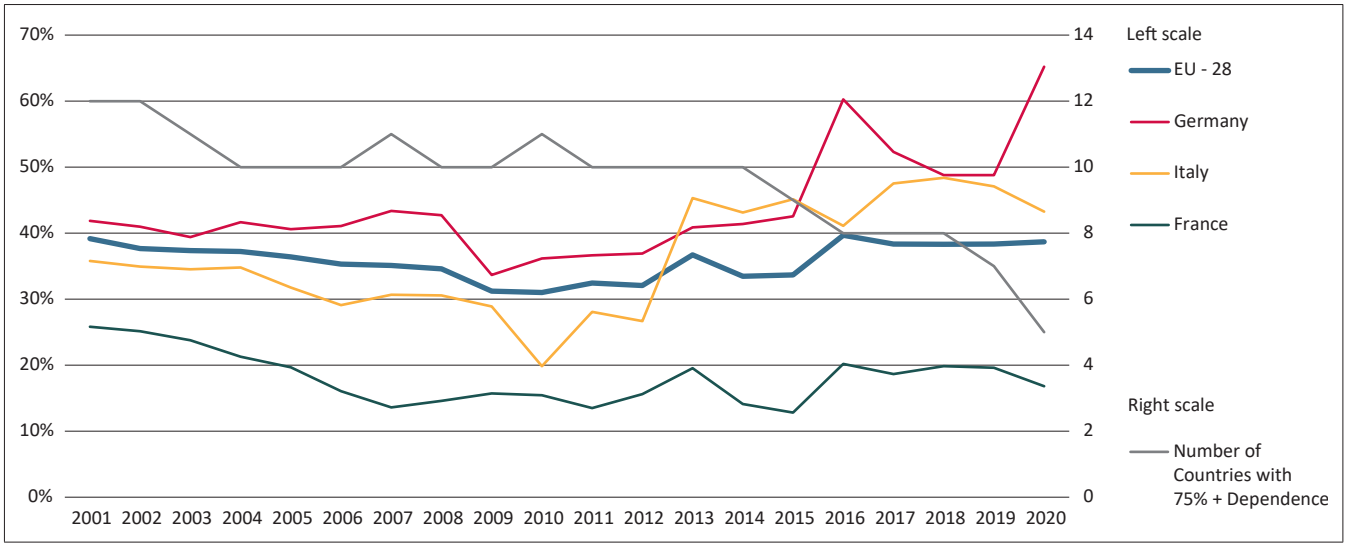
Additionally, Russian oil companies have a strong presence on the Italian market. Lukoil has full ownership

[1] Shentov, O., Stefanov, R., and Vladimirov, M. (eds.), *The Kremlin Playbook in Europe*, Sofia: Center for the Study of Democracy, 2020.

KEY POINTS

- The current geopolitical crisis has demonstrated that Italy needs to put **energy security and its governance** back at the top of its policy priorities.
- Italy has emerged as one of the most **vulnerable countries** in terms of security of supply concerns and **geopolitical exposure** to Russia.
- The concurrent expansion of **natural gas use in the power and industrial sectors** made for a perfect storm when gas supply shortages in 2021 pushed global prices up and led to a severe deterioration of the **affordability risks**.
- The short-term policy focus on **supply diversification** should not undermine the longer-term and more sustainable objective of completely **phasing out natural gas** from domestic consumption.
- The National Energy and Climate Plan should be revised in 2023 so that the renewables target is raised in line with other European countries and a 2035 **clean power commitment** should be imposed.
- The Plan's **low carbon priorities need to be reinvented** and aligned better with the country's energy transition goals.
- Decarbonizing energy markets will deliver a blow to **Kremlin's ambition** to increase its **economic and political influence** in Italy and in Europe.

Figure 1. Share of Russian Gas in Total Gas Imports in Selected European Countries



***Source**: CSD calculations based on Eurostat data.*

of the Priolo refinery, which has a strategic role as the main supplier of oil products and electricity in Sicily. Though the most obvious red flag, this is just the tip of the iceberg of the deeply rooted corporate networks linked to the Kremlin, which channel Russia's economic and political influence in Italy, and help undermine European energy and climate security.

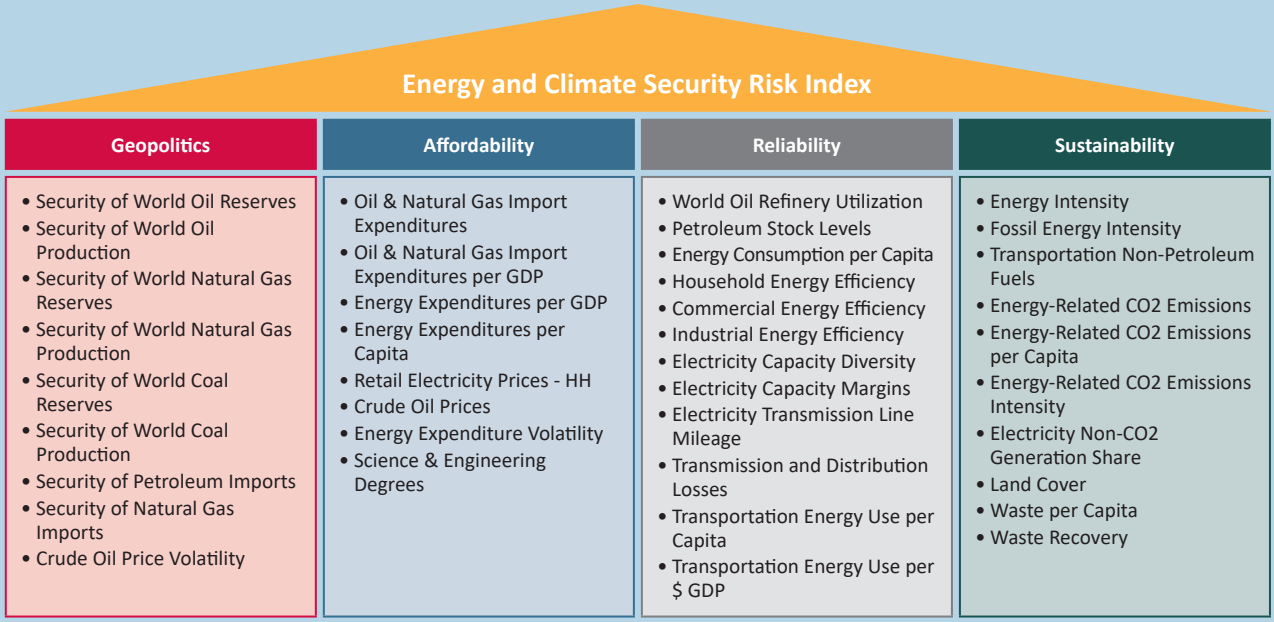
The EU has complacently, and at its own peril, lost sight of the energy policy trilemma it formulated at the turn of the century – to reconcile energy transition with security and competitiveness – even as the risks have increased following Russia's annexation of Crimea and the rise of China as a global geopolitical rival. The current crisis has demonstrated that Italy, specifically, and Europe, more generally, needs to put energy security and its governance back at the top of their policy priorities. Re-establishing energy security as a core element of the Italian energy strategy and synchronising energy security with decarbonisation and European market integration and liberalisation policies is a crucial step for the country's long-term policy objectives. It is essential to take this step as soon as possible to ensure the long-term sustainability of energy governance and investments.

Russia has repeatedly challenged the EU's energy transition strategy. Back in 2009, when the EU tried to conceive its energy union, the Kremlin launched its divisive geopolitical gas pincer projects of Nord Stream and South Stream, denouncing EU energy transition goals as naïve. Now, with the war in Ukraine and the related hybrid disinformation assaults on Europe, it has tried to undermine the fundamental legitimacy of EU governance and has put pressure on the European Green Deal by blowing up the continent's energy security. The Kremlin is waging a gas and oil war of attrition on Europe. This requires a swift, sustained and robust joint response from the EU and its member states, which calls for special attention on strengthening the governance mechanisms for achieving the EU's joint energy transition and security goals. Evidence-based policy instruments to monitor the progress of member-states are necessary to ensure an objective, comparative assessment of the state and the dynamics of their energy and climate security risks if Europe is to win the standoff with Russia and achieve its long-term decarbonisation goals. Such an instrument would enable the deepening of the coordination of national policies across sectors and policy areas on the back of a long-term political, financial and social commitment.

The Energy and Climate Security Risk Index (ECSRI)

The ECSRI is an evidence-based policy instrument that can help track the most important energy security and climate vulnerabilities faced by EU Member States based on data-driven policy assessment. The Index has four pillars[2], reflecting the four dimensions of energy security: geopolitics, affordability, reliability, and sustainability.

Figure 2. The Pillars of the Energy and Climate Security Risks Index



***Source**: CSD.*

The ECSRI covers 42 individual risk indicators, based on thousands of data points, all of them interpreted through the prism of strengthening Europe's energy independence and transition potential. While these factors apply to different elements of energy and climate security, they are often interdependent, allowing for a systemic analysis of energy and climate policy trends. For instance, there is a strong link between the movement of crude oil prices, energy expenditures and the fossil-fuel energy intensity of the economy, which provides for an in-depth understanding of the decarbonisation/energy poverty nexus. Similarly, the level of oil and gas consumption on the national level impacts energy import expenditures, especially for countries with a high security of imports risk (reflected in the Geopolitical pillar). Meanwhile, oil and gas consumption patterns also directly impact the carbon intensity of the economy and its level of greenhouse gas (GHG) emissions, a key indicator in the Sustainability pillar.

The individual risks are measured in different units, such as EUR cents per kWh for retail electricity prices or tons of oil equivalent (toe) per EUR 1000 GDP for the fossil energy intensity of the economy. However, the data is normalized into comparable indicators and assembled into an index. The index reflects the relative change of the level of energy and climate security risk over time, relative to 2015.

The choice of 2015 as the base year reflects the immediate aftermath of the Russian annexation of Crimea, which is a key turning point in the geopolitics of European energy and represents a missed opportunity for improving the continent's energy security. The decline in oil and gas prices in 2015 created favourable conditions for the diversification of energy supply, while the Kremlin aggression in Crimea and Donbas should have incentivised European countries to reconsider their structural energy dependence on Russia.

[2] Modelled after the Index of U.S. Energy Security Risk developed by the Global Energy Institute.

Energy and Climate Security Risk in Italy

Italy's energy and climate security risk position has moved more or less in sync with the general EU trend since 2015. Most EU countries have made significant progress in decarbonising their energy sectors, increasing the share of renewables in power generation and boosting energy efficiency. Over the past decade, Italy's sustainability risks have gone down by a quarter on the back of the rise in the renewable energy's share in final energy demand. Reliability risks have also followed suit as both businesses and households have invested heavily in reducing energy demand. Despite these significant improvements, Italy's total energy and climate security risk index score has actually stayed flat due to the sharp increase in geopolitical and related affordability risks linked to the rise in global energy prices and the increase in the country's dependence on Russian natural gas imports, most notably in 2021.

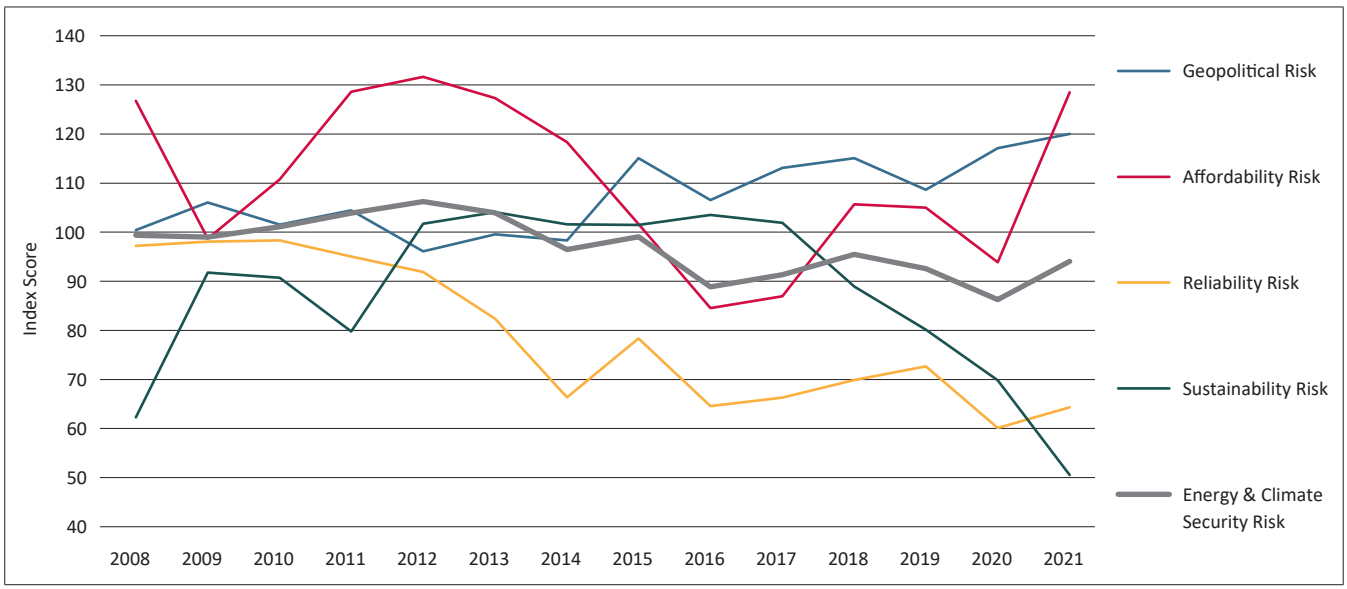
Despite the rising geopolitical tensions following Russia's annexation of Crimea, the EU in general, and Italy in particular, locked themselves further in an excessive energy dependence on Russian supply. The concurrent expansion of natural gas use in the power generation and industrial sectors made for a perfect storm when gas supply shortages in 2021 pushed global prices up. The domino effect on electricity tariffs, coupled with global oil market disruptions, led to a severe deterioration of affordability risks. The energy poverty level among households rose and Italy faced an ever-greater energy import bill.[3]

Geopolitical Risk

The geopolitical risk indicators mainly reflect global energy market trends and the level of energy import dependence. Hence, individual countries have little control over these factors and can only focus on ensuring a more diverse energy mix that can diminish the reliance on supply from authoritarian states controlling a large share of the available energy resources in the vicinity of European markets. Finding alternative deliveries can also somewhat shield countries from the volatility of global oil and gas prices and can optimize the costs of energy.

In the past decade, Italy has become more vulnerable to potential oil and gas supply disruptions, thereby weakening Europe's energy security position in the process. Italy saw its share of Russian gas in total natural gas imports expand from 29% in 2009 to 47% in 2019 on the back of deepening ties between the largest Italian natural gas companies and Gazprom, the overall growth of gas demand and dwindling domestic output.

Figure 3. Italy's Energy & Climate Security Risks Dynamics (2008-2021)



***Source**: CSD.*

[3] Rangelova, K. and Valdimirov, M., "Beasts from the East and Energy Price Horrors in Europe," *CSD blog post*, December 2021.

Italy's increased reliance on Russian natural gas has in turn weakened EU's energy security position. Italy has continuously backed the key Kremlin-led geopolitical projects, South Stream (and its TurkStream reincarnation) and Nord Stream (I and II), providing them with political support but also participating in the financing, insurance and construction of the pipelines. As a result, Italy now accounts for roughly a fifth of the EU's total natural gas imports from Russia. It has also contributed 18% to the overall growth of Russian gas deliveries to the EU between 2014 and 2021.

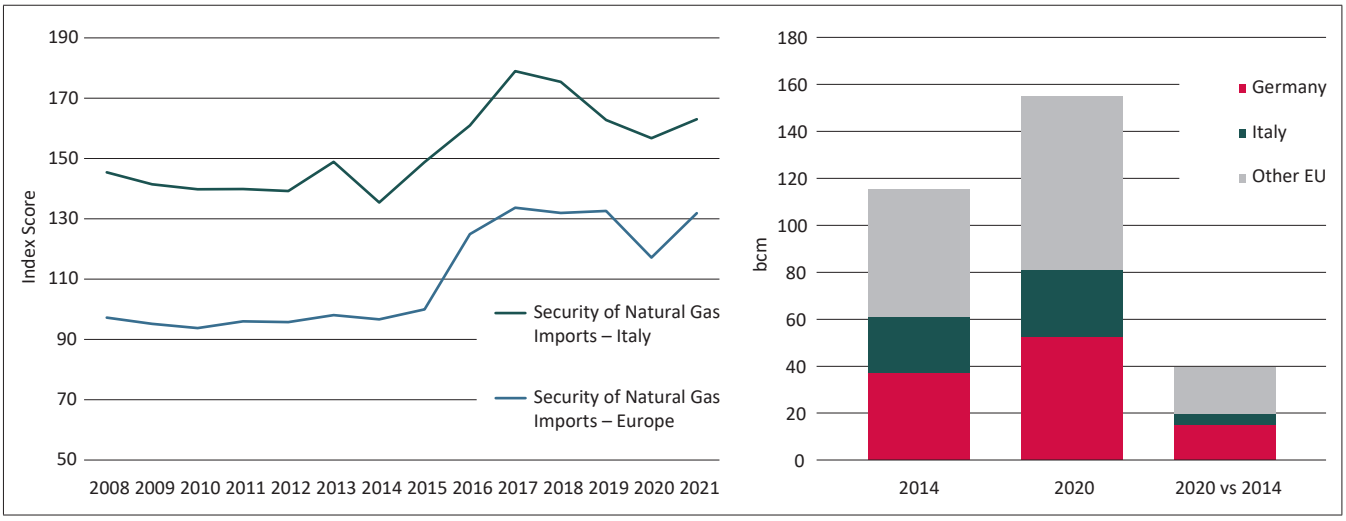
Italy's increased gas dependence on Russia has been surprising, provided the wide array of options the country has had at its disposal to diversify its imports, including existing trade and infrastructure ties with other producers. Italy has access to two alternative pipeline routes, the Greenstream connection to Algeria and the Transadriatic Pipeline (TAP) link to Greece (and to Azeri gas by extension). The two pipelines have a spare capacity of 7.8 and 11.5 billion cubic meters, respectively. Italy also has three LNG regasification terminals that are underutilized and can potentially provide a diverse and abundant gas supply from the global market.[4] LNG deliveries are the more viable option, as both Algeria and Azerbaijan have a very limited potential to raise gas exports.

Reducing the dependence on Russian gas will improve Italy's natural gas import security risk but the effect on the freedom score subcomponent is unclear as the country would likely become more reliant on other authoritarian states that are major gas supplier. This is why the short-term policy focus on supply diversification should not undermine the longer-term and more sustainable option for reducing energy security risks, namely the complete phase-out of natural gas from domestic consumption and imports.

The Kremlin's aggressive foreign policy has been indirectly emboldened by Italy, which, among other European countries, has refused to rethink its strategic business relationship with Russian state-owned and (state-directed) private entities. Even in the immediate aftermath of the Russian invasion in Ukraine in February 2022, many in Italy initially opposed sanctions against the Kremlin, such as for example the exclusion of Russia from the SWIFT payments system, as to ensure the payment of energy supplies.[5]

More recently, Italy and Germany have allowed energy companies to open rouble accounts in Gazprombank and continue buying Russian gas, after the Kremlin issued a unilateral mandate that all payments from the so-called "unfriendly states" are facilitated via euro/dollar to rouble currency exchanges.[6] Other EU member states, such as Bulgaria, Poland, Finland, Denmark and some Dutch companies that have refused to accept this new payment scheme, which apparently

Figure 4. Security of Natural Gas Imports Score and Imports of Russian Gas (Italy vs EU)



***Source**: CSD.*

[4] Bianchi, M. and Raimondi, P., *Russian Energy Exports and the Conflict in Ukraine: What Options for Italy and the EU?*, Istituto Affari Internazionali, March 12, 2022.

[5] Merrick, R., "Ukraine: Germany and Italy have 'disgraced themselves' over Russia sanctions, Donald Tusk says," *The Independent*, February 25, 2022.

[6] Jewkes, S. and Wacket, M., "Germany and Italy approved Russian gas payments after nod from Brussels," *Reuters*, May 20, 2022.

has in many cases meant a unilateral change in delivery contracts, have seen their Russian natural gas imports cut.[7] These differences in responses have exposed the critical vulnerabilities of some EU countries, most notably Italy and Germany, to Russian gas extortion. These vulnerabilities have been further exploited by Kremlin propaganda and disinformation, hurting EU's unity and capacity to respond to Russia's aggression in Ukraine. Even worse, the acceptance of Gazprom-proposed payment schemes contributed to the gas supply interruptions Italy and other EU members have experienced in mid-June, 2022, as Russia seeks to increase its pressure on Europe to renounce its sanctions policy.

Affordability Risk

The Affordability pillar assesses the impact of energy prices and energy imports on macroeconomic stability, as well as the level of energy poverty. Some of the indicators directly show the effect on energy prices, in particular of crude oil, natural gas and electricity, on household and business consumers. Furthermore, the Affordability sub-index considers national expenditures on oil and gas imports and their weight relative to national GDP. Overall energy expenditures are strongly affected not only by the price level of different energy sources, but also by the fuel mix, consumer choices, and energy efficiency. In this sense, high energy consumption and the use of more expensive fuels strongly influence affordability risks.

Total energy expenditures and their weight in national GDP have decreased by between 5-10% in Italy over the past decade. This is the result of the improvement of energy and transportation efficiency, the increase of the share of electricity in the energy mix and the relative decline in the volatility of energy prices, at least until 2021. Nonetheless, Affordability is the most important component of the total energy and climate security risk in Italy and is mainly driven by the high share of oil and gas in the final energy demand. Together they account for over 50% of households' and 70% of non-households' final energy demand.

CO_2 prices[8] make up the largest share (around 25%) of the Affordability sub-index in 2021, up from less than 5% in 2015. The rising fossil fuel energy prices on global markets, exacerbated by the war in Ukraine, has focused popular and policy attention on carbon pricing, putting pressure on the EU's energy transition goals. This is a key pressure point that the Kremlin could seek to exploit as the war of attrition drags on. Increasing carbon costs are a critical market signal for the acceleration of the decarbonisation process. They speed up the phase out of inherently volatile fossil fuels from the market and enable higher investments in renewable energy, which would subsequently make energy cheaper, more secure and more readily available. But the short-term affordability pain of the concurrently rising fossil fuel and carbon prices could break the political support for energy transition, the sanctions on Russia or both. Italy is particularly vulnerable to pressure in this respect.

The Affordability sub-risk category's components have strongly fluctuated both in Italy and across the EU since 2008 due to the strong volatility in oil and gas prices. The surge in the price of oil, natural gas and CO_2 have deepened the affordability crisis in Italy. The country was one of the hardest hit EU member states by skyrocketing power prices, which have shot up due to the excessive dependence of power generation on natural gas. The concurrent high gas and power prices have undermined the competitiveness of the Italian industry, putting additional downward pressure on the already sluggish economic growth in the past decade. Wholesale power prices almost tripled in 2021 on the back of the country's dependence on natural gas. As retail power prices increased precipitously and Italians took to the streets in early 2022,[9] the Italian government implemented a EUR 6 billion price-capping scheme to support households and enterprises in covering their energy bills,[10] on top of direct social transfers to low-income households[11] and support for energy efficiency upgrades.[12] The rising costs of financing on the global markets are likely to put a hard ceiling on the Italian government's capacity to further ease affordability

[7] Partridge, J., "Russia cuts gas supplies to Netherlands and firms in Denmark and Germany," *The Guardian*, May 31, 2022.

[8] The CO_2 costs indicator measures the cost of verified emissions based on ETS prices and the difference between total verified emissions and freely allocated emissions (the cost is negative when freely allocated emissions exceed total verified emissions)

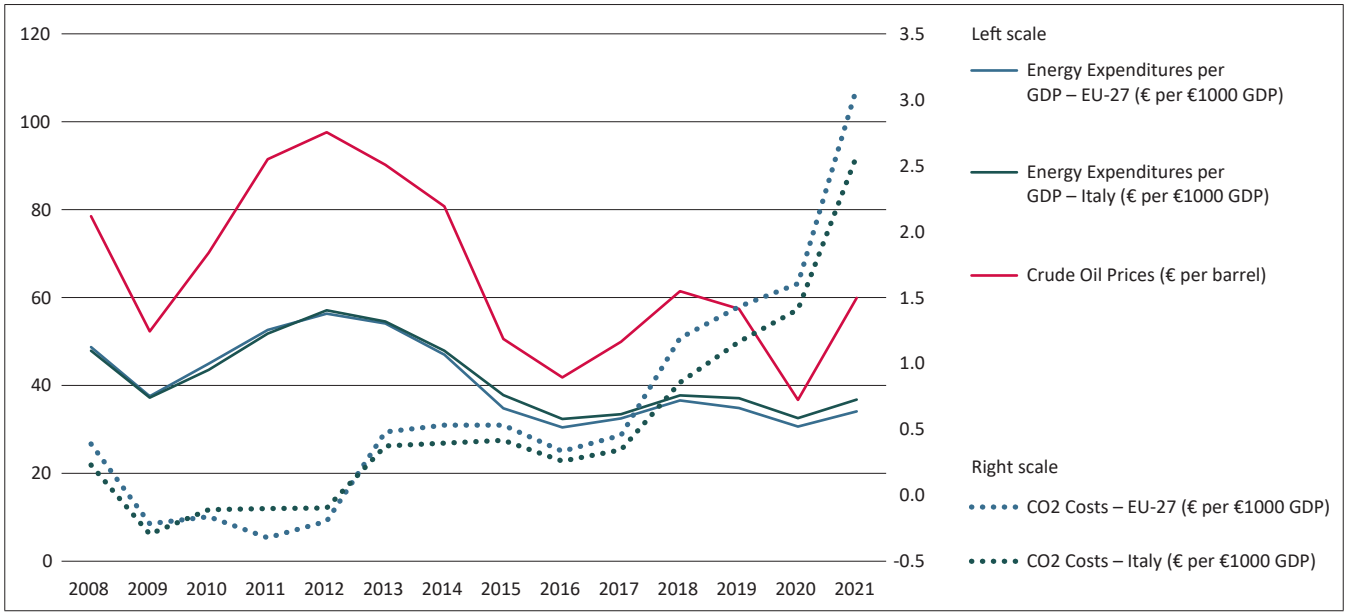
[9] Il Sole 24 Ore, "Caro bollette: dallo sport ai comuni, monta la protesta. Oggi i sindaci spengono le città," February 10, 2022.

[10] Fonte, G. and Jones, G., "Italy approves 8 bln euro package to help economy, curb energy bills," *Reuters*, February 18, 2022.

[11] Autorità di Regolazione per Energia Reti e Ambiente, Bonus sociali.

[12] Ministero dello sviluppo economico, Incentivi per l'efficienza energetica.

Figure 5. Energy Expenditures per GDP vs Crude Oil Prices and CO2 Costs (Italy vs EU)



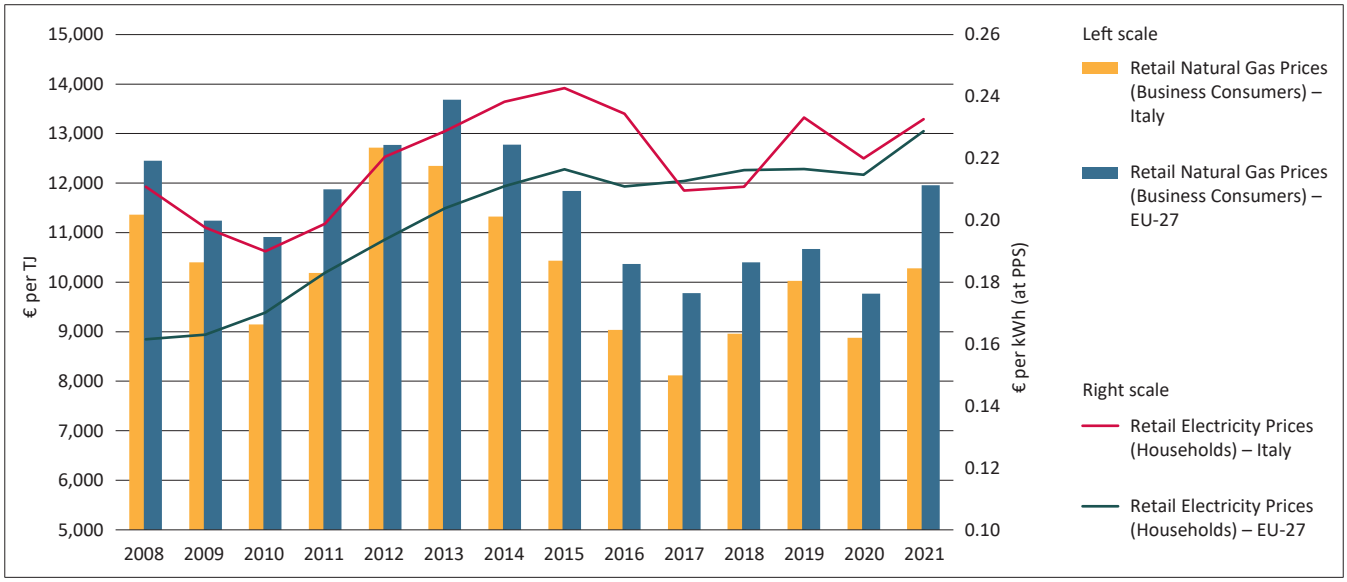
***Source**: CSD.*

pains through fiscal spending. This will make Italy more vulnerable to continuing short-term gas blackmail from the Kremlin.

Structurally, the most important factor exacerbating the nexus between energy supply and affordability pressures in Italy is the expanding dependence of the Italian power sector on natural gas. The share of gas in power generation rose from 24.4% in 2016 to 46.5% in 2021. Italy has 44.2 GW of installed natural gas plants and another approximately 14 GW (38 more units) in the pipeline to be added to the electricity system by 2030. Installed natural gas capacity more than doubled over 2016-2021, as the Italian energy majors have moved to replace the oil-based generation units, still a major component in the power mix in many parts of the country, with natural gas.

The Italian government does not have major plans to reduce the country's natural gas dependence to the same degree as most of the other EU member states. By 2030, according to the country's National Energy

Figure 6. Natural Gas and Electricity Prices (Italy vs EU)



***Source**: CSD based on Eurostat data.*

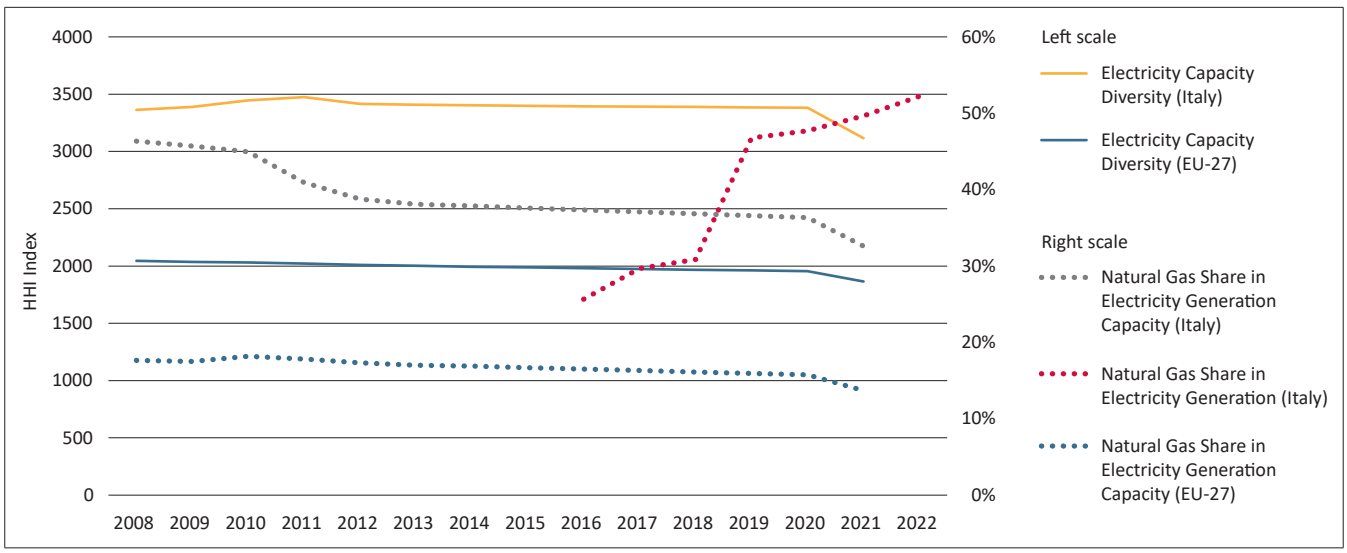
and Climate Plan (NECP), natural gas will still make up 38% of the power generation mix, one of the highest shares in Europe. The decision to extend the natural gas dependence has been closely associated with the existence of a state capacity mechanism that provides for long-term power purchasing agreements (PPAs) from 2024 to 2040. Through these PPAs, the Italian state, through a competitive bidding procedure, provides gas plant investors with a financial incentive worth around EUR 70/kW/year (around EUR 35 million for a 500 MW plant, for example). This guarantees a secured cash flow for new gas installations even if they cannot reach their technical capacity factor of 60%. The decision to remain hooked on gas comes even as generating electricity in Italy from natural gas has already become three times more expensive than onshore wind and solar PV-based plants.[13]

Reliability Risk

The Reliability pillar reflects the exposure of the national economy and different sectors to potential energy supply disruptions. This includes a wide variety of factors, such as national petroleum/gas stocks, the spare capacity of the global oil refining industry, the resilience of the national electricity system, the energy intensity of the national industrial, commercial, and household sectors, as well as the role of the transport sector in the national economy. The risks for the electricity and natural gas system are of particular importance amid growing electrification, on the one hand, and the mounting challenges linked to the excessive dependence on Russian supply.

The main Reliability risk indicator in Italy is the low electricity capacity diversity, which has not improved since 2008 and which is close to 70% below the EU average. The excessive dependence on natural gas in the power sector is the main factor for the low capacity diversity. As Italy imports most of the natural gas it consumes, the reliability of power supply is the direct product of the predictability and diversity of gas deliveries from a few, largely authoritarian, countries. As the Kremlin's war in Ukraine has demonstrated, Italy is vulnerable to import shocks related to geopolitical crises that could cripple the electricity system. Italy gets around 40% of its natural gas from Russia (29 billion cubic meters per year), which means that it would be very difficult to fully diversify away from Gazprom in the short run despite pledges by the Italian government to do so. The Russian cut in the natural gas supply could cause disruptions on the power market or at the very least, increase electricity prices to politically unsustainable levels. The alternative to Russia would be an even greater dependence on Algeria, which already supplies around a third of the country's needs, as well as

Figure 7. Electricity Capacity Diversity and Natural Gas Share (Italy vs EU)



***Source**: CSD.*

[13] Brown, S., "Gas-reliant Italy lags behind in Europe's race to renewables," *Ember*, December 9, 2021.

several other sources, including Qatar and Azerbaijan. This is not a long-term solution as security of supply risks will persist, albeit at a lower intensity. Hence, there is a clear urgency to reduce Italy's overall natural gas consumption and gradually phase it out from power generation by replacing it with renewables and power storage systems. Governing this transition at the Italian and EU level in the face of mounting Russian pressure on European energy security would be a critical challenge to national and European policy-makers. This calls for Italy and Europe to move to the next level of energy market integration and the introduction of new, more agile governance mechanisms that would manage better the geoeconomic risks for the country and the EU.

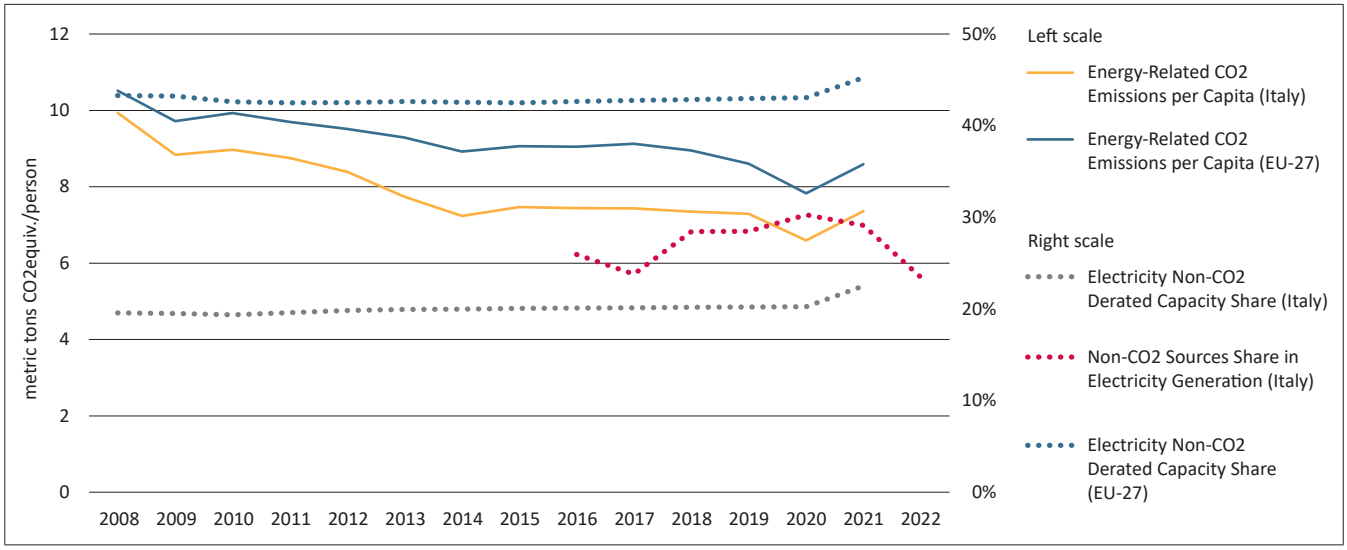
Sustainability Risk

The Sustainability pillar includes the climate and environmental factors that affect the sustainability of the national economy and its alignment with key EU climate objectives. Key risk factors include the emission intensity of the energy sector and the share of fossil fuels in key sectors such as electricity generation and transport, as well as in the overall national economy. It also includes a risk metric that evaluates the level of circularity of the national economy and the sustainability of land use.

Despite the general European decarbonization trend over the past decade, Italy has seen a slower reduction of its sustainability risks (-17,4%) compared to the EU (-21,3%). There has been a minor improvement in energy-related emissions per capita since 2014 (-1,4%) compared to the EU-27 (-5,2%). Italy is also lagging behind in the share of non-CO2 electricity capacity, with a 22% share compared to the 45% of the EU. Between 2015 and 2020, Italy added only 5 GW worth of wind and solar plants while adding another 20 GW of gas.[14] Italy is also much less ambitious than its European peers in terms of energy transition targets. While most of South and Northwestern Europe have RES targets of above 70% in the electricity sector, the Italian NECP envisions that renewables cover just 55% of the final power demand by 2030. And if hydro power is excluded (also quite volatile due to climate change), the wind and solar share will be just around a third of total electricity consumption despite the country's enormous potential.

Moreover, Italy's sustainability risks could further deteriorate as a result of the geopolitical crisis and the affordability nexus. The rise of natural gas prices and the growing Russia-related security of supply risks has expanded the role of coal in the power mix. Coal-fired power generation doubled year-on-year since the start of the war in Ukraine in February 2022, reaching a 10% market share in power generation. At the same time, hydropower generation has halved, as water reservoirs have dropped to historical lows.

Figure 8. Sustainability Risk Key Metrics (Italy vs EU)



***Source**: CSD based on the EECSRI, ENTSOE data (electricity generation data).*

[14] Jones, D., *Global Electricity Review 2021*, Ember, March 29, 2021.

Unlocking the wind and solar energy potential of the country and integrating demand response in balancing services is critical for tackling the overreliance on natural gas and the geopolitical, affordability and reliability risks associated with it. Italy's weak ambition on key sustainability policies, such as renewable energy development and energy efficiency, have limited the country's ability to deal with the current energy crisis and become more resilient to external shocks. To improve the investment climate for renewables, the government should reform the capacity market so that natural gas does not receive preferential treatment. Natural gas investment could lead to stranded assets worth EUR 11 billion, funds that could be diverted to the improvement of the grid and in storage capacity to enable a smoother integration of renewables en masse.[15]

Understanding the Geopolitical Risk to Energy and Climate Security: The Kremlin Playbook in Italy

Since the dawn of the Cold War, Italy and Russia have enjoyed special economic and political relations due, in large, measure to Moscow's ties with one of Europe's strongest communist parties, the Italian Communist Party. This generated "ideological sympathies" that paralleled Italy's growing dependency on Russian energy. Italian firms such as Fiat (now Fiat-Chrysler) and the state-controlled Italian energy firm ENI were early European investors in the Soviet Union. Italy's foreign and trade policy toward the Soviet Union, and subsequently toward Russia, was designed first and foremost to promote Italian business interests there. These established relationships have only strengthened since the collapse of the Soviet Union, as Russia has reinforced its strategic partnerships with important Italian economic and political players. The EU and Italy have repeatedly downplayed possible energy, economic, technological, and wider security concerns of this rising interdependence, even as Russia reversed its course towards democratization in the mid-1990s.

Today, Italy is Russia's third-largest commercial partner in Europe, and its fourth in the world. However, imports from Russia make up only around 3% of the total in Italy while exports to Russia are less than 2% of the total. Similarly, although some of the largest Russian and Italian companies have cooperated in high-profile energy, finance and telecommunication deals over the past two decades, total foreign direct investments from Russia are just over EUR 2 billion and Italian investments in Russia have declined from EUR 11 billion in 2016 to EUR 4 billion today. The Russian corporate footprint expressed in Russian companies' turnover/assets out of the total in the Italian economy has remained below 0.5% and has declined since the annexation of Crimea.

However, Italian companies have important economic interests in Russia. These include some of the structurally most important Italian businesses, including ENI (oil and gas), ENEL (electricity generator), Pirelli (tires), and Leonardo (aerospace and defense). After the imposition of sanctions against Russia in 2014, these entities have reportedly lobbied the Italian government indirectly against the imposition and rollover of EU sanctions on Russia by underscoring the risk of retaliatory sanctions and their impact on the companies' bottom lines.[16] Italian banks remain major financiers of Russian state and private companies including underwriting some of the biggest energy infrastructure projects led by Russia (including South Stream and Nord Stream). The total financial exposure of Italian banks to Russia is estimated at EUR 24.5 billion, second only to that of French banks. In fact, together with Austria and France, Italy is among the very few countries that increased their financial exposure to business with Russian companies after 2014. Unicredit is the largest foreign bank in Russia in terms of volume of activities,[17] with 105 branches and more than 1 million retail clients. Intesa Sanpaolo has a strong presence in the Russian credit market, handling more than half of the economic and financial transactions between Russian and Italian companies and being involved in the financing of major projects, such as the Nord Stream gas pipeline.

Rolling back this banking dependence in the wake of the Kremlin's war in Ukraine will cause a hit to some of the biggest Italian banks, which have struggled to cut their business ties with Russia. The major threat from the exposure of financial institutions and investments to Russia is the potential losses they will incur as Russian companies fail to repay credit lines due to the

[15] Carbon Tracker, *Foot Off the Gas: Why Italy should invest in clean energy*, March 23, 2021.

[16] Ibid.

[17] InfoMercatiEsteri, Farnesina, Ministero degli Affari Esteri e della Cooperazione Internazional.

sanctions and the seizure of assets, as well as due to the likely upcoming economic recession in Russia.[18]

Italy's economic exposure to Russia, in particular the involvement of major industrial actors and banks with close ties to the Italian political establishment, has dampened Italy's resolve for sanctions. After the start of the war in Ukraine in February 2022, Italian entities sought to delay sanctions against Russia's energy sector. Matteo Salvini, the leader of the Lega party – formerly the Northern League and one of the biggest groups in the Italian Parliament – initially warned against imposing sanctions to Russia, as those measures would have "exclusively affected poorer households and Italy's energy supplies".[19] In a similar fashion, the Five Star Movement did not firmly back the sanctions.

In fact, Lega and M5S have consistently distanced themselves from criticising Russian actions in Ukraine since the annexation of Crimea in 2014.[20] In 2018, Lega and M5S formed a coalition government which confirmed their opposition against Russian sanctions, fostering the recovery of economic ties and dialogue between the EU and Russia.[21] This political support from Italy strengthened economic ties with Russia, expanding Russian influence in the Italian economic and political sphere, with cases of Russia allegedly financing disinformation campaigns to influence elections in the country.[22] This has subsequently emboldened and enabled the Kremlin's aggression in Ukraine, and has made the EU's adequate response much more difficult and painful.

Box: Russian Financing of Political Parties in Italy

A journalistic investigation exposed an alleged agreement between representatives of the Lega party and Russian petroleum oligarchs[23] to receive indirect financing for the then-upcoming European Elections in May 2019. On 18 October 2018, Gianluca Savoini, spokesperson of Lega leader Matteo Salvini and founder of the Cultural Association Lombardy Russia, met with other Italian and Russian businessmen in Moscow to conclude a trade agreement for 3 million barrels (EUR 1,5 billion) of gasoil between Rosneft and ENI. The intermediaries involved in the deal would have received a EUR 65 million commission on these transactions, which were to be later transferred to Lega-related individuals and funds. The journalist's reporting led to a police investigation of a possible international corruption scheme although it is yet unknown whether illicit funding of Lega actually occurred.

The geographical distribution of most Russia-owned companies in Italy shows that the Russian footprint is most visible in Northern and Central Italy. The strong opposition to Russian sanctions from Lega might have been influenced by the strong Russian presence in Italy's Northern regions, where Lega is most influential. Also, Lega could have seized this opportunity to strengthen its political position, as the sanctions would have mainly affected the most productive companies located in this area.

Italian oil and gas companies have played a central role in locking the national economy in an import dependence on Russia. Doing business for decades with Russian companies close to the Kremlin has facilitated a number of lucrative deals for Italian majors. ENI has spearheaded these efforts since the end of the Cold War. The Italian company formed a strategic partnership with Gazprom starting in 1999 when the two formed a special-purpose joint venture (registered in the Netherlands) to build the Blue Stream gas pipeline on the Black Sea seabed, in which ENI retains a 50 percent stake.[24] Building on this relationship, both firms signed a new memorandum of understanding in 2007 to construct the South Stream gas pipeline across Central and Southeastern Europe and through the Western Balkans. In 2012, ENI signed additional energy deals with the Russian state-owned oil behemoth Rosneft for an agreement to explore and produce in Egypt's Zohr offshore field, in the Black Sea, and in the Barents Sea in the Arctic.

[18] Za, V., "Explainer: Global banks count cost of Russia exposure," *Reuters*, March 18, 2022.

[19] De Cicco, L. and Vitale, G., "Salvini anti sanzioni, Conte cauto. Letta: "Troppe posizioni filorusse,", *La Repubblica*, February 24, 2022.

[20] Vecchio, C., "Dai viaggi in Crimea al piano del Cremlino. Il lungo flirt Lega-Mosca," *La Repubblica*, March 27, 2022.

[21] Castelletti, R., "Salvini: "Sanzioni alla Russia inutili, pronti ad agire. Ma siamo soli contro il mondo"," *La Repubblica*, June 25, 2018.

[22] Ellyatt, H. and Bercetche, J., "Russia is set to gain from the Italian election result. Here's how," *CNBC*, March 6, 2018.

[23] Tizian, G. and Vergine, S., "La trattativa segreta per finanziare con soldi russi la Lega di Matteo Salvini," *L'Espresso*, February 21, 2019.

[24] ENI, "Blue Stream," September 25, 2018.

Gazprom also entered the Italian gas market directly through an agreement with ENI, which allowed the Russian company to participate in transporting and distributing Russian natural gas in Italy via the TAG gas pipeline concession. Italy represents a key market for Gazprom exports, with ENI being the largest single natural gas buyer from the Russian company.[25] Despite initially suspending the signing of any new agreements with Russia,[26] ENI has reportedly begun the process of opening two accounts with Gazprombank – one in roubles and one in euros — to continue paying for Russian natural gas under the Kremlin-proposed scheme. This has not stopped Gazprom from severely reducing the gas deliveries to the company.

In addition to ENI, the Italian company Edison has developed a number of strategic deals with different Russian energy firms. However, the Italian gas and power supplier has announced plans not to renew its supply contract with Gazprom in 2023.[27]

In the oil sector, in 2008, the largest Russian private oil company, Lukoil, acquired 49 % of ISAB, the third-largest refinery in Europe, located in Sicily. Lukoil has since increased its stake to 80 %, giving it control over a strategically-located refinery on the Mediterranean that employs over 1,000 people,[28] and providing vital investment in a region where unemployment is 21.5 % and the GDP per capita is only 62 percent of the national average.[29] Despite the EU decision to ban oil imports from Russia by the end of 2022, the ISAB refinery has moved to consume 100% Russian oil as its price has tumbled amid the push by European companies to diversify away from Russia. Lukoil's decision to double down on Russian crude imports has prompted the Italian government to mull the partial nationalization of the refinery to ensure the fulfillment of the embargo.

Outside oil and gas, the Russian company Renova controls several different Italian power generation firms specialized in the development and operation of wind farms, photovoltaic and hydropower plants.

In addition to the energy sector, Russian firms have gained importance in different strategic Italian sectors, such as the joint venture between Novolipetsk Steel (NLMK) and Duferco, an important Italian steel company, and the acquisition of a steel plates production firm by the Russian group Evraz. The telecommunications sector has also been the target of large Russian investments over the years with VEON, the biggest Russian telecom, acquiring 50% control of Wind Tre S.p.A., the biggest mobile operator in Italy.

The strong presence of Russian private and state-owned companies in the energy sector represents an additional geopolitical risk that goes beyond the structural trade dependence on oil and gas. The strong economic connection between the largest Italian and Russia energy providers will affect the position of the Italian government, which could be forced to accept Russia-imposed conditions or to oppose EU sanctions on Russia. In this context, the decoupling from the Russian corporate presence in the Italian energy sector could enable the successful diversification of oil and gas supply and facilitate the implementation of the EU sanctions. It will also strengthen Italy's position to prioritize energy transition goals and contribute more to the EU's energy resilience.

What's Next: Strengthening Italy's Energy and Climate Security

Decoupling from Russia

The Russian economic influence in the Italian energy sector shows the importance of cutting all structural business ties with the Kremlin. There is an urgent need for establishing credible and efficient investment screening mechanisms and for halting Russian strategic investments in Italy linked to Russian state-owned companies and oligarchic networks close to the Kremlin.

In the short run, Italy also needs to ensure that Russian energy companies comply with the oil embargo and diversify their crude imports. Italian importers of natural gas need to commit to not renewing their long-term supply agreements with Gazprom and to renounce any unilateral changes to the contractual terms that could undermine the common EU position on energy security and diversification.

The shift away from Russian energy dependence will drastically reduce the Russian economic footprint in

[25] Ibid.

[26] Jewkes, S., "Eni suspends the purchase of oil from Russia," *Reuters*, March 9, 2022.

[27] La Repubblica, "Emergenza energetica, Edison: "Le priorità sono diversificazione e sicurezza," March 9, 2022.

[28] Bousso, R. and Zhdannikov, D., "Russia's Lukoil puts Italian refinery up for sale – sources," *Reuters*, September 20, 2017.

[29] DG Growth, "Sicily," European Commission, December 18, 2018.

Italy as most of the trade and investment between the two countries happens in the energy sector. This would require the immediate freezing of joint ventures for oil and gas exploration and the divestment of Italian companies from energy production and infrastructure projects in Russia and elsewhere in Europe. Italy should adapt its legislation to be able to place under operational control Russia-owned assets in strategic sectors, such as energy infrastructure, i.e. the ISAB refinery in Sicily.

In the medium-term, Italy should focus on completely phasing out Russian oil and gas from its energy supply. The country has abundant available capacity to import both crude oil and gas from alternative suppliers including via LNG and pipelines from North Africa and Azerbaijan. Even more importantly, Italy should begin talks with local energy companies that have a long pipeline of natural gas projects, including power plants, to redirect their efforts and funds to low-carbon initiatives as to avoid stranded assets and strategically reduce the country's gas dependence. In this respect, there is an urgent need to reform the capacity market so as not to provide preferential treatment to natural gas investors. The capacity tenders from 2022 and 2023 should be rerun as to prevent excessive reliance on natural gas in the short term when the risk of a gas supply cut is the highest.

Going through the winter period 2022/2023 without Russian gas would not be possible without severe cuts in Italy's gas consumption, provided the necessary planning is set in motion and adhered to at a national and European level. Italy should introduce a demand response mechanism that is based on tertiary sector tenders where industrial consumers are compensated for cutting their gas use for a specific period of time. Italy could also introduce a special funding envelope that would cover deep energy efficiency investments aimed at replacing natural gas from the industry and the residential sector.

Concurrently, Italy should aim to overcome the affordability risks related to the oil and gas supply crisis. Italy should increase its financial support for vulnerable consumers who will be most affected by the likely spike in energy prices over the winter of 2022/2023. The government is already implementing social bonuses and energy price-capping schemes, but due to the country's high debt levels and budgetary constraints, it is crucial that the support only targets low-income households and small businesses as to prevent misdirected public funding that only entrenches wasteful energy consumption patterns.

A Roadmap to a new energy and climate security strategy

As suggested by the Energy and Climate Security Risk Index, Italy needs to focus primarily on reducing its energy sector dependence on natural gas by diversifying away from Russia in the short run and phasing out gas completely in the medium run. Cutting the use of natural gas will improve the sustainability, resilience and affordability of power generation in the country, creating an electricity system which is less dependent on and affected by external factors. Decoupling from Russian energy could reduce geopolitical risks in the long run, although security of supply cuts is not to be ruled out in the short term due to the country's excessive dependence on Gazprom. It could also be expected that mounting price pressure would weaken popular support for EU's sanctions against Russia. Meanwhile, focusing energy policy efforts on the decarbonization of the energy system would have the strongest impact on improving the nexus of affordability and geopolitical challenges.

As highlighted by the Index results, Italy faces structural energy and climate security risks that can be overcome only by a set of long-term coherent governance policy efforts at the national and EU level:

- Take decisive steps towards a full natural gas phase out by 2035, which requires the discontinuing of a number of gas-fired power plant projects and a strong push for the electrification of buildings and the industry. The benefits of phasing-out natural gas are two-fold. First, substituting natural gas with renewable energy systems will dramatically reduce emissions and CO_2 costs, which will drive down energy prices and reduce energy poverty. Second, phasing out gas will reduce geopolitical risks as Italy remains heavily dependent on imports from authoritarian states. Even if Russian supply is replaced, Italy would remain exposed to possible geopolitical turmoil and political instability related to the nature of the regimes that are the chief alternative exporters of natural gas.

- Promote renewables deployment with strategic investments in grid resilience and in power storage systems that will take away the need for fossil fuel-based balancing. There is a need to reinvent the low-carbon priorities of the National Recovery and Resilience Plan so that they are better aligned with the country's decarbonization goals. The current resources allocated to green transition measures and renewables investments make up

only 16% of the total spending and would produce only incremental advances in climate transition considering the economy-wide challenge of a fossil-fuel lock-in.[30]

- EU and state public funding streams should be directed towards the increase of electrification and the improvement of the resilience of the electricity system.

- The NECP should be revised in 2023 so that the RES target is increased in line with other European countries and a 2035 clean power commitment should be imposed. To unlock the deployment of renewable energy sources on a massive scale, there is a need to eliminate regulatory and administrative barriers to wind and solar investments including those linked to property issues, construction permits and conflicts with other activities.

- The employment of renewables for the electrification of the transport sector is essential, as Italy has one of the most energy-intensive transportation systems in Europe, one that still relies mainly on fossil-fuels.

- Enable deep electrification based on cutting-edge renewable energy technologies such as offshore wind, green hydrogen and synthetic fuels in industry and low-carbon transport infrastructure.

- Make energy efficiency a top priority for Italian policy-makers. There is a need for deep renovation programs to reduce energy consumption faster than the current 2030 targets.

In the long run, a full fossil fuel phase-out is the most sustainable way to improve energy and climate security. Decarbonizing energy markets will also deliver a blow to the Kremlin's ambition to increase its economic and political influence in Italy and in Europe. A critical element for effectively delivering this strategy would require an overhaul and strengthening of the EU energy security governance to include credible mechanisms for shielding Europe from further aggression from the Kremlin. This calls for the reinforcement of the EU's Democracy Action Plan measures to deter the Kremlin Playbook in Europe, including, among others, investment and sanctions screening, coordination of energy security risk mitigation strategies, asset tracking and joint anti-money laundering enforcement.

[30] Leonardi, M., Bellisai, F., and Heilmann, F., *Green Recovery Tracker Report: Italy*, 2021.