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THE RUSSIAN-UKRAINIAN GAS CONFLICT

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Analysis

The Russo-Ukrainian Gas Dispute, 2009

By Simon Pirani, Oxford

Abstract

The Russo-Ukrainian gas dispute, which has apparently just been resolved at the time of writing, is the most serious yet. The two sides were close to reaching agreement in October, and may eventually return to the framework established then. But sharply deteriorating economic conditions, resulting from the financial crisis and falling oil prices, have stoked the conflict, and helped to make both sides willing to prolong it. Russia's determination to solve what it sees as an intractable problem with Ukrainian gas transit is a more significant factor than the influence of oligarchs.

The Culmination of a Long Process

Russia's "gas war" with Ukraine this month continues a dispute that has turned nasty periodically since 1991. It is by far the most serious confrontation yet. Imports from central Asia via Russia to Ukraine stopped on 1 January, and from Russia via Ukraine to 18 other European countries on 6 January. In Bulgaria and other Balkan countries heavily dependent on imported Russian gas, many residents lost their heating and a humanitarian crisis resulted. The Russian and Ukrainian governments signed an agreement on 19 January that should result in supplies being resumed both to Ukraine and beyond, although the sides did not make public some details while others remained unsettled.

In the gas sphere, Russia and Ukraine remain bound to each other by Soviet-era infrastructure, long after other economic and political ties have weakened. Four-fifths of Gazprom's exports to Europe, its prime source of revenue, go through Ukraine's pipelines. Ukrainian industries, heating networks and housing, all designed to use then-cheap Soviet gas, remain, 20 years later, heavily dependent on mainly Turkmen supplies provided by Gazprom. (See Table 1 on p. 5.)

Supplies to Europe have been interrupted once before, in January 2006. Then, Gazprom was demanding an increase in Ukrainian import prices to European netback levels (i.e. to the level that its European customers pay, with the cost of transport through Ukraine, Slovakia and the Czech republic deducted). It also wanted to pay to transport gas through Ukraine in cash, instead of with the biggest of all remaining post-Soviet barter transactions (transit-for-gas).

The agreement that ended the 2006 dispute was good for Gazprom, inasmuch as it did away with barter deals and direct Ukrainian negotiations with central Asian suppliers, mainly Turkmenistan. Since then, Gazprom has bought all the gas central Asia sends west, and resold most of it to Rosukrenergo, a Swiss trading company owned by Gazprom (50%) and Ukrainian businessmen Dmitry Firtash (45%) and Ivan Fursin (5%), which then resells it in Ukraine. (Rosukrenergo was the last of a series of intermediary companies used by Gazprom to transport and/or resell central Asian gas to Ukraine. The practice began in the mid-1990s when barter was predominant and the entire gas trade unstable; its persistence into the 2000s has been criticized because of its opacity and the resulting scope for corruption, and because of favoritism shown by Gazprom to the intermediaries' owners.) The deal's negative aspects, from Gazprom's standpoint, were that Ukrainian import prices stayed far below European netback levels (See Table 2 on p. 6). And whereas in Belarus, Gazprom bought 50 percent of the pipeline company in 2007, Ukraine has refused to contemplate even partial Gazprom ownership.

When Yulia Timoshenko, the multi-millionaire former gas trader, returned to the Ukrainian prime minister's office in December 2007, renewed conflict seemed likely. She was determined to remove Rosukrenergo and its part owner Firtash from the gas trade. She ordered that Rosukrenergo and its affiliates be frozen out, leading to a brief "gas war" in March 2008. But then Moscow indicated it was ready to dispense with Firtash at year's end, and the conflict subsided.

So Near to Agreement, and Yet so Far

By October 2008, it seemed that Russia and Ukraine were ready to put their gas relationships on a new footing. Timoshenko and Russian Prime Minister Vladimir Putin signed a memorandum that provided for both import prices and transit tariffs to reach "market, economically based" levels (read, European netback) within three years; Gazprom would sell central Asian gas to Naftogaz Ukrainy, the Ukrainian state company (i.e. Rosukrenergo would lose its lucrative transit contract); and Gazprom subsidiaries would no longer be unwelcome in the Ukrainian domestic market. The deal, backed by a corporate agreement between Gazprom and

Naftogaz, was to be finalized once Ukraine had cleared debts for gas received.

Why did it all go wrong?

Firstly, because Ukraine failed to clear the debts promptly as it had agreed. Secondly, because the two sides failed to agree on how exactly European netback prices should be arrived at.

There were powerful economic factors that drove the dispute. Oil prices had reached an all-time high in July 2008 and were falling in the late summer; after the Wall Street financial meltdown of September, they plunged. Russia's oil boom was over. European gas prices are tied (indirectly, via oil products) to oil prices, but with a six- or nine-month delay. So Gazprom knew that, by mid-2009, its European revenues, too, would be slashed. Its managers were in no mood to give up a single kopeck.

The coming recession is hitting Ukraine even harder than Russia, as the IMF recognized by granting it a record-breaking $16.5 billion loan. The price of steel, Ukraine's main export, has sunk; most of its mills have lost up to half of their output and more than half of their revenues. December's industrial production was down 26.6% year-on-year.

Perversely, this gave Ukraine room for maneuver, gas-wise. The world's most energy-inefficient economy was contracting, for the first time this decade, and so needed less gas. Mild weather late last year helped. Naftogaz had 17 billion cubic meters (bcm), about one-third of Ukraine's annual import requirement, in storage. Some politicians may have decided this was the best time for a prolonged dispute with Russia.

Ukraine failed to pay its debt for last year's imports ($1.5 billion, it says; $2.2 billion including late payment penalties, Russia says) until 31 December. Along with the money, Naftogaz sent a letter saying that if Ukrainian supplies were cut, it would divert to its customers volumes bound for Europe, as it had in 2006. Gazprom had been publicly threatening to cut off Ukraine for two weeks already. On 1 January it did so.

How Europe Became Embroiled

Even at this stage, a deal seemed close. On 31 December, Putin said it should be done on import prices of $250 per thousand cubic metres (/mcm). On 1 January, Timoshenko and president Viktor Yushchenko, in a rare show of unity, proposed $201/mcm and an increased tariff for transiting Russian gas to Europe.

But the leaders displayed little will to clear away practical obstacles. Naftogaz promised to transit gas to Europe even while its own imports had ceased. But on a legalistic pretext, it added that, until new contracts were signed, it could not supply technical gas (i.e. amounts required to power compressors and other equipment) as transit countries normally do. It would take these from the Russian gas provided. Gazprom countered that this was "theft", no better than the crude siphoning of the 1990s.

On 5 January, Gazprom cut the volumes going into the pipes by about one fifth, arguing that Ukraine should replace the technical gas it had taken; on 6 January, Gazprom cut volumes by a further three-fifths. In the early hours of 7 January, the system was shut down completely and Russian deliveries into it stopped. Both sides blame the other: Russia says Ukraine stopped accepting deliveries, Ukraine says Russia stopped making them. Neither outside observers, nor even some people in the industry, yet know the real story. But it became obvious in succeeding days that both sides were happy to sit it out, however many households in the Balkans froze.

The European Commission, which had prior to 6 January kept aloof, now called both sides to Brussels, and suggested sending monitors to gas metering stations, to help avoid more rows about which gas was going where. An agreement was drawn up, but when Timoshenko signed it, she added reference to a list of conditions to which she knew Gazprom could not agree. On 13 January Gazprom agreed to supply gas via one pipeline only (out of five main ones), but Ukraine said it could not transport it without disrupting its own consumers. The next day, as demonstrators clashed with police in Sofia, negotiators agreed to meet … after another three days.

On 19 January, both sides announced that they had resolved the dispute. Gazprom and Naftogaz signed two separate ten-year agreements, one on gas supplies to Ukraine and one on transit. Putin and Timoshenko announced that in 2009 discounts would be applied both to Ukraine's import bill (by 20%), and Russia's transit bill (it will stay at the 2008 level), but that from 2010 – a year earlier than they had previously envisaged – prices would be set at European netback and transit fees at a European comparator. Rosukrenergo would lose its transit contract.

At the time of writing, the exact price of Ukrainian imports in 2009 had not been agreed. Gazprom said gas would start flowing immediately after the signing, and would take about 36 hours to reach European destinations.

Motivations

During the dispute, with European gas prices at their peak, Gazprom has been losing close to $100 million a day in revenues after costs. It has lodged cases against Naftogaz at the international arbitration court in Stockholm, but it will be years, if ever, before it recovers anything that way. More importantly, the unprecedented interruption to European supplies has cost Gazprom more than money. It has suffered damage, probably permanent, to its reputation as a reliable supplier – which was already under constant attack from commentators, often ill-informed, who see Russian gas primarily as a geopolitical "weapon".

What would make Moscow prolong such an expensive stand-off? Evidently, it has been decided at the government level that pursuing, and somehow punishing, Ukraine is worth risking a great deal. This conflict is not simply about gas prices. The gap between Putin's $250/mcm and Yushchenko-Timoshenko's $201/mcm is roughly $2–2.5 billion a year in revenue, to be shared with traders and central Asian producers – compared to $30–40 billion from European sales.

A more plausible interpretation is that people in the Russian government hope that, by embroiling Europe in the dispute, a new modus operandi can be established for the Ukrainian pipeline system. Much of what Europeans usually term Russian supply risk is actually Ukrainian transit risk, and that concerns Moscow. Ukraine's readiness to divert gas bound for Europe, as it did in 2006, has been a trump card in negotiations. On one hand, Russian suggestions that Ukraine might relinquish control over the system to pay its gas debts, as Belarus did, meet blanket and understandable political opposition in Kiev. On the other, Naftogaz has failed to raise money to refurbish the system, and struggles even to maintain it.

Gazprom managers, in response to what they see as an intractable obstacle, after 2006 pressed ahead with projects such as the North Stream and South Stream pipelines, aimed at reducing transit dependence on Ukraine. But these won't be ready for three more years at best, and won't cut out Ukraine all together even then. For Moscow, control of the Ukrainian network remains the favored option. But, short of that, it would prefer closer European engagement with transit issues. Putin resurrected the idea of an international consortium to take over the system in a recent interview. And the heads of German and Italian energy companies, Gazprom's most important European partners, met with Putin on 15 January to discuss how to resolve the sticking-point on technical gas.

What about the oligarchs, the politically-influential businessmen so prominent in Russia and Ukraine? The press is full of suggestions that, while public attention focuses on the governments, "the real fight over the share-out [of gas revenues] is taking place more discreetly between a few oligarchs in Moscow and Kiev", as a comment contributed to the *Financial Times* (6 January) put it. But there is no evidence that Ukrainian gas oligarchs matter sufficiently to the Russian government, or have sufficient influence on it, to provoke a clash on this scale.

Take Dmitry Firtash, the most significant of them. His businesses are relatively opaque, as are his political connections, but the main sources of revenue are known. Assuming that Rosukrenergo loses the contract to ship central Asian gas to Ukraine – as it will if the agreements signed on 19 January are implemented – it may continue selling 7+ bcm/year of central Asian gas in central Europe (extremely profitable) and buying local gas distribution networks in Ukraine (extremely unprofitable, so far). Firtash's companies also manufacture chemicals, and trade gas and electricity in central Europe. All significant – but no reason for Gazprom to put its European revenues on the line.

Prices and Transit Tariffs

The Putin-Timoshenko memorandum proposed that Ukrainian import prices should rise to "market" (in practice, European netback) levels in three annual steps. A Ukrainian government memorandum to the IMF said domestic prices should rise in the same way.

The two prime ministers said on 19 January that they are now hoping to reach European netback prices for Ukraine by 2010, a year earlier than they had initially planned. The real struggle for Ukraine will be this year, because European prices will reflect record-high oil prices in 2008. In the first half of this year, European prices will be roughly $450/mcm; that, less transport costs and a 20% discount, is about $325/mcm. In the second half of 2009, European prices will be about $350/mcm. If they stay at that level in 2010, European netback in Ukraine would be $306/mcm; if they fell to their average level in 2006–07, roughly $250/mcm, European netback in Ukraine would be a little higher than $200/mcm.

Ukraine also insists that transit tariffs, now $1.70/mcm per 100 km, should rise. Czech and Slovak tariffs, the best comparators, are not made public. But there seems to be a large differential, more than 100 percent, just as there is on gas import prices. If the gap in prices isn't closed in one jump, the two sides will not be able to close the gap in transit tariffs either. Moscow might engage with the figure in the Timoshenko-Yushchenko memorandum, $2/mcm per 100 km, but not with the $3.60-4/mcm per 100 km mentioned later by Yushchenko.

Consequences

The most immediate consequence of the dispute will probably be an acceleration of North Stream, South Stream and other projects to diversify transit of Russian gas away from Ukraine, on which Gazprom has agreed with European energy companies, but on which construction has not yet begun. European politicians will talk about projects to diversify supply of gas away from Russia, and alternative fuels. But such plans will remain constrained by European energy companies, who will prefer to adapt their long-standing relationship with Gazprom than to make big investments in other uncertain energy sources.

This could be the "war to end wars" in Russo-Ukrainian gas relations. Short term, it may mean changes in Ukrainian transit arrangements. Certainly, once transit diversification projects are completed, the Ukrainian pipelines will be less important to Russia, and less of a bargaining chip for Ukraine. In the best case, Ukraine will get serious about energy efficiency, the only effective way for it to reduce dependence on imported gas in the long term.

About the author:
Simon Pirani is a senior research fellow in the Natural Gas Programme at the Oxford Institute for Energy Studies. He is the author of an extended research paper, Ukraine's Gas Sector (OIES, 2007), and a monograph on Soviet labor history, *The Russian Revolution in Retreat, 1920–24* (Routledge, 2008).

Further reading:
- Simon Pirani (ed.), *Russian and CIS Gas Markets and Their Impact on Europe* (Oxford University Press, forthcoming in February 2009)
- Simon Pirani, Jonathan Stern and Katja Yafimava, *The Russo-Ukrainian gas dispute of January 2009* (OIES, forthcoming in February 2009)

Tables and Graphs

The Gas Dispute in Figures

Table 1: The Russo-Ukrainian Gas Trade: An Outline

Imports

	2003	2004	2005	2006	2007	2008 (est.)
Ukraine, consumption	68.7	68.1	68.9	65.9	62.8	60
Ukraine, technical requirements	7.6	7.6	7.4	8.1	7.0	7
Ukraine imports (presumed)	56.9	55.4	55.8	53.3	49.1	47
Ukraine production		19.4	20.3	20.5	20.7	20.7
Price ($/mcm)	$50	$50	$44–80	$95	$130	$179.5
Total value of imports, bn $ (estimates)	$2.84bn	$2.77bn	$3.2bn	$5.06bn	$6.38bn	$8.44bn

Transit

Volumes transported, bcm/year						
To Europe	112.4	120.3	121.5	113.8	112.1	113
To the CIS*	16.8	16.8	14.9	14.7	3.1	3
Cost of transit $/100km/mcm	(barter)	(barter)	$1.09	$1.60	$1.60	$1.70
Value of transit services, bn $ (estimates)	$1.48bn	(n/a)	$1.5bn	$2.2bn	$2.1bn	$2.2bn

** These are volumes transited to Moldova, and via eastern Ukraine to southern Russia. The latter volumes were sharply reduced in 2007 due to new internal Russian pipelines being commissioned.*
Source: statistics from Energobiznes, based on information from the fuel and energy ministry (consumption, import, production); Naftogaz Ukrainy (transit volumes); author's calculations

Table 2: European Border Prices, Ukrainian Netback and Actual Import Prices ($/mcm)

	Price at European border (estimate)	Transport through Ukraine, Slovakia and Czech rep.	Netback price at Russo-Ukrainian border	Actual import prices	Differential between actual prices and European netback
2004	143.05	27.00	116.05	50	66.05
2005	189.31	31.58	157.73	50–80	77.73–107.73
2006	246.51	36.53	209.98	95	114.98
2007	254.48	38.35	216.13	130	86.13
2008 (est.)	368.32	41.13	327.19	179.50	147.69

Source: Gas Strategies, transit companies, author's calculations

Table 3: Gas transported through Ukraine (bcm)

Year	Total	To Europe	To CIS
2000	123.6	109.3	11.3
2001	124.4	105.3	19.1
2002	121.6	106.1	15.1
2003	129.2	112.4	16.8
2004	137.1	120.3	16.8
2005	136.4	121.5	14.9
2006	128.5	113.8	14.7
2007	115.2	112.1	3.1

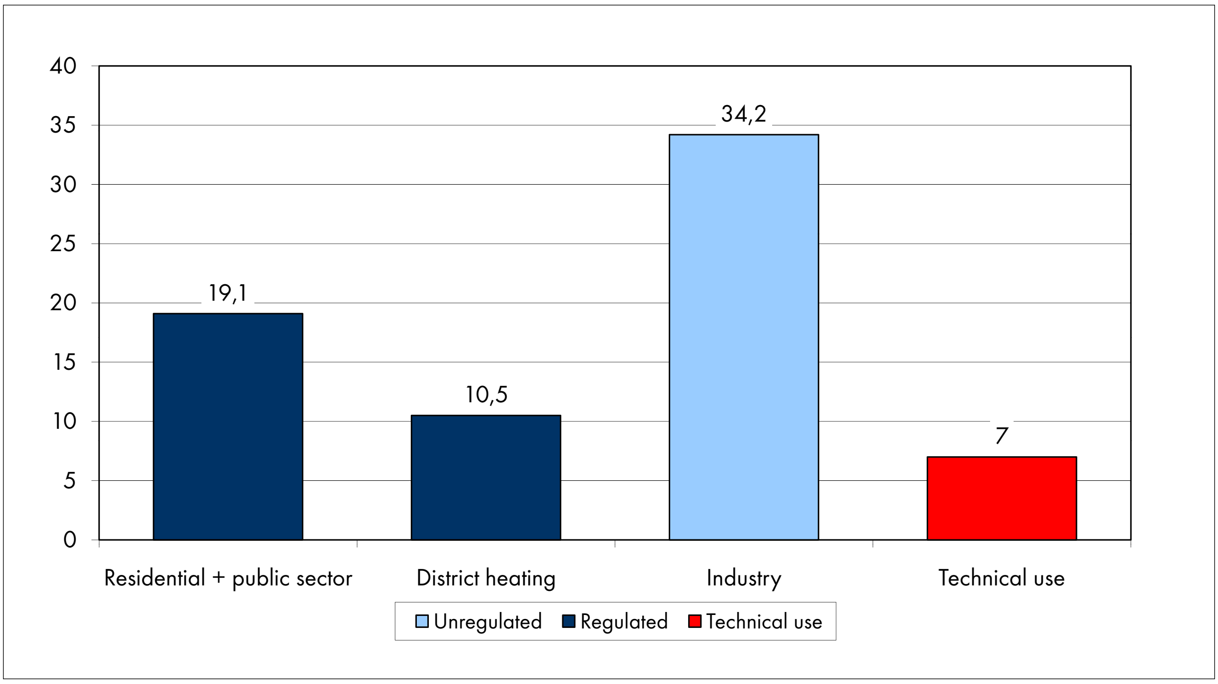
Note: Excludes volumes for domestic use
Note: the main explanation for the drop in transit volumes to the CIS in 2007 is that Russian gas formerly transported through eastern Ukraine back into southern Russia is now taken by a different route via Russian territory
Source: Naftogaz Ukrainy

Table 4: Consumption of Gas in Ukraine 2003–07

	2003	2004	2005	2006	2007
Consumers:	***68.7***	***68.1***	***68.9***	***65.9***	***62.8***
Industry (excluding power)	27.3	28.2	29.0	24.3	25.8
incl. metals industry	9.8	9.9	9.6	9.3	9.8
chemicals industry	8.5	8.3	8.8	-**	-**
Other industrial users	9.0	10.0	10.7	-**	-**
Power industry	7.0	6.7	5.7	8.6	8.4
Via local government*	34.3	33.1	34.1	34.2	29.6
incl. dist. heating co's	14.4	13.5	13.7	12.8	10.5
Technical use:	***7.6***	***7.6***	***7.4***	***8.1***	***7.0***
Ukrtransgaz	6.6	6.8	6.6	6.0	5.2
Other	0.8	0.8	0.8	2.1	1.7
Total consumption in Ukraine	***76.3***	***75.8***	***76.4***	***73.9***	***69.8***

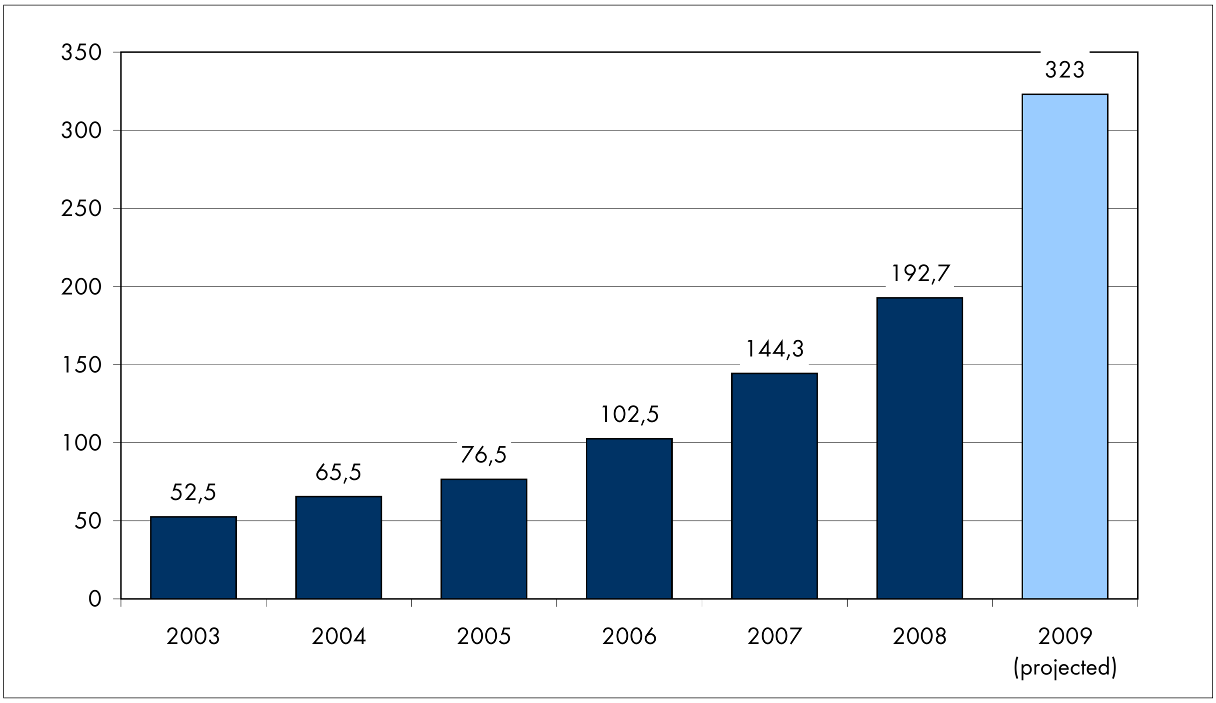
** This category is accounted for via the public sector, and includes (a) residential consumers; (b) all state-financed organisations (i.e. municipal, schools, hospitals etc); and (c) district heating companies. A separated-out figure is given only for district heating companies; of the remainder, about 2–3 bcm is for state-financed organisations.*
*** The statistics for 2006–07 did not give separate amounts for the chemicals industry, etc.*
Source: Energobiznes, based on information from the fuel and energy ministry

Ukraine's Domestic Gas Market (2007, bcm)



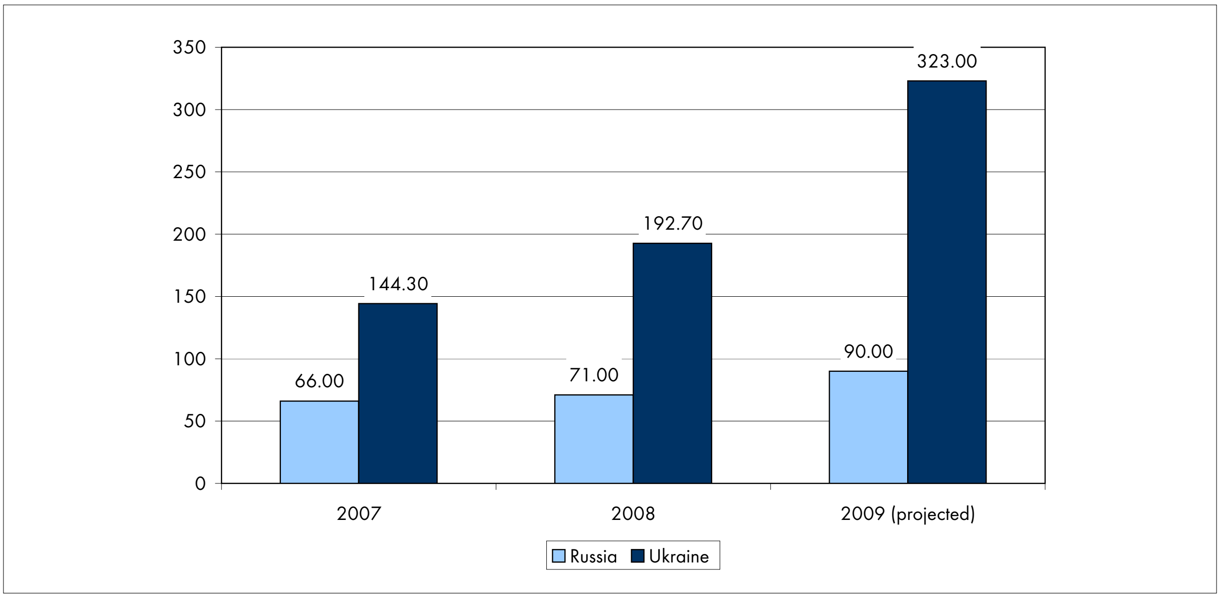
Source: Energobiznes, based on information form the fuel and energy ministry

Market Prices for Ukrainian Industry ($/mcm)



Source: industry information

Russia vs. Ukraine: Gas Prices for Industry; Average (Analysts' Estimates) ($/mcm)



Source: analysts' estimates

Documentation

Gazprom's Statement on the Agreement of 19 January 2009 with Ukraine

Speaking to journalists during a conference call today Gazprom's Deputy CEO Alexander Medvedev confirmed that contracts had been signed with Ukraine for both the supply of gas to the Ukraine and transit of Russian gas to Europe:

- The signing of the contracts, both of which cover 10-year terms, is a major achievement
- 2009 is the last year of discounted prices for natural gas as well as special transit rate for transit via Ukraine. In 2010, Ukraine will pay European prices for supply and Gazprom will pay European prices for transit.
- Assuming Ukraine's future compliance with the contracts, there should never be a repeat of this winter's situation (interruption of transit supplies to Europe). Both contracts contain internal mechanisms to prevent non-compliance, including a clause covering advance payment in the event of lack of payment by Ukraine for the gas it receives.
- Today, in accordance with the agreements, the flow of natural gas from Russia to Europe started at 10am. Today, the volume should reach 423.8 million cubic metres of gas.
- Gazprom reserves the right to claim for any damages suffered over the last month, but in respect of the supply and transit contracts and outstanding debts, Gazprom and Ukraine have found a solution to settle the dispute.
- Following the agreement of new contracts, there is no need for the monitoring system to continue. Unfortunately the function of the international monitoring system was not performed in full, with monitors unable to enter Ukraine's underground storage facilities to assess the situation.
- In 2009 the average price paid by Ukraine will be below $250/1000cm, given the falling price of crude oil and oil products. European customers are likely to pay around $280/1000cm. In 2010, the transit rate will increase to a level of around $2.50 per 1000cm per 100km, so Ukraine's transit revenues of Ukraine will increase by about 50%, given the current forecast of natural gas prices.
- Over the period of the dispute Gazprom lost approximately $100m per day as a result of not being able to supply its European customers, but the company believes that a substantial part of these losses will be covered over the coming days and months due the need to refill underground storage facilities and the high level of demand from customers. Gazprom's investment programme has not been affected and projects such as Nord Stream, Shtokman and Yamal will continue as planned.
- The dispute has emphasised the need for South Stream – it is clear that the sooner this diversification of transit routes takes place, the better for Europe. This is not only in respect of political risk, but also technical risk.

Source: http://www.gazpromukrainefacts.com

Analysis

Intermediaries and the Ukrainian Domestic Dimension of the Gas Conflict

By Margarita M. Balmaceda, Cambridge, MA

Abstract

On January 1, 2009, Russia suspended gas supplies to Ukraine, while continuing transit supplies to Europe. On January 7, all supplies to or through Ukraine were suspended. Complex negotiations brokered by the EU followed, leading to a monitoring mechanism intended to assure transit shipments would reach the EU despite the Russian-Ukrainian dispute. By January 19, despite the agreement, gas still failed to flow. This article looks into the causes of the January 2009 gas trade conflict between Ukraine and Russia and especially considers the role of intermediaries as well as Ukraine's complicated domestic situation.

Corruption in the Ukrainian Energy Sector as a Key Problem

The longstanding divisions of the political and economic landscape in Ukraine are an essential source of the recurring frictions in Russian-Ukrainian energy relations. In fact, energy is a prime example of Ukraine's difficulty in delimiting a distinct "Ukrainian" national interest, separate from Russia's. This breakdown is related to the elites' failure to fully comprehend Ukraine's situation of energy dependency until well into the mid-2000s, and to the structure of interests created by significant possibilities for corruption and rent-seeking in the area.

Especially during Leonid Kuchma's presidency (1994-2005), energy market transactions offered rich profit-making opportunity for those with the right connections. The rent-seeking opportunities were related to the manipulation of prices through barter trade; re-export of low-cost Russian oil and gas; the system of selective payments for gas from the state budget to private (but not public) companies; the profits accrued through the selective allocation of the most lucrative gas distribution contracts; the transfer of liability for non-payments to the state, and the de-facto joint "theft" of Gazprom's gas from Ukrainian pipelines.

Common to all these areas of potential rent-seeking was that profits were mostly made not at the expense of Gazprom or the Russian state, but the Ukrainian state budget and the Ukrainian people. Energy corruption severely hindered Ukraine's ability to agree on and implement a proactive energy policy, exactly at a time when Russia was becoming more proactive in this area. While the Ukrainian state was bleeding from inside as a result of such corruption, official gas prices paid by Ukraine for imports from Russia remained relatively low and largely stable: until 2005, Ukraine largely bartered transit services for gas supplies from Russia (which did not prevent significant debt problems from arising regularly, however).

Despite Viktor Yushchenko's campaign against the legacy of the Kuchma-era corruption, under his leadership the energy business continued to be a prime area of rent-seeking, corruption and competition between "clans." In fact, Yulia Tymoshenko's dismissal as prime minister in September 2005 is believed to have been triggered by her team's interference with the energy rent-seeking activities attributed to the Yushchenko entourage.

The Russia-Ukrainian 2006 Agreements and their Implications

An additional low point in Russian-Ukrainian energy relations came in the form of the January 4, 2006, agreements with Russia that brought to an end the three-day stoppage of gas supplies by Gazprom that sent shivers throughout Europe. It is essential to understand the content and implications of this agreement in order to grasp which issues were at stake in the 2008–09 negotiations.

After 2006, the Russia-Ukrainian energy business did not become more transparent. One reason was the strengthening of intermediary companies. Although intermediaries have long played a role in the Ukrainian-Central Asian gas trade, their role changed significantly after the January 4, 2006, agreements. If in the 1990s and early 2000s intermediary companies (such as ITERA and Eural Trans Gas) were paid large sums to organize the transport of Central Asian gas to Ukraine, under the new agreements of 2006, the company RosUkrEnergo, created in 2004 as a Swiss-registered joint venture between Gazprom and Austria's Centragas, became not just the transporter, but also the operator of all Ukrainian gas imports from Central Asia and Russia, giving the company much more power in the relationship.

On the Ukrainian domestic gas distribution market, the January 2006 agreements led to the creation of a new intermediary, UkrGazEnergo. UkrGazEnergo was created in February 2006 as a joint venture and given the right to distribute gas directly to industrial users in Ukraine, thus taking away from Naftogaz the financially strongest domestic consumers. As a result, UkrGazEnergo retained the profits, while Naftogaz not only lost its main source of profits, but continued to be contractually obliged to supply district heating companies and residential users, often unable to pay, bringing the company dangerously close to bankruptcy.

Apart from the enhanced power of intermediaries, the new agreement was detrimental to Ukrainian interests because, while it was agreed that gas prices would be revised yearly, Ukraine was locked until 2010 into accepting low transit fees (lower than those typically paid within the EU, but higher than the fees Belarus received). Also, the 2006 agreements further reduced Ukraine's ability to truly diversify its gas supplies, as they remained contractually tied to a single supplier (RosUkrEnergo) which in turn was tied to Russia, regardless of whether the imported gas actually came from Russia, Central Asia, or both.

Thus, when the two sides began negotiations in 2008 over the new prices and trade conditions, it was largely the legacy of the 2006 agreements that prevented finding a deal that would suit all parties involved.

The 2008 Negotiations and the Role of Intermediaries

Energy relations between Ukraine and Russia already saw serious strains in late February 2008, but were brought back to normal after Tymoshenko's March 12, 2008, negotiations in Moscow. Essentially, it was agreed that intermediaries would be removed: UkrGazEnergo (effective from March 1, 2008) and RosUkrEnergo (effective "some months later"). The Russian side agreed, but in return demanded that prices would increase (an additional 1.4 bcm of Russian gas was acknowledged as debt) and, as a replacement for UkrGazEnergo, Gazprom was promised the right to sell at least 7.5 bcm of gas directly to Ukrainian industrial users.

Despite some uncertainly about these agreements (they were called into question by President Yushchenko, and partially superseded by a new set of agreements signed by him on March 19), energy relations with Russia appeared to be going relatively smoothly in the following months. Discussions on RosUkrEnergo subsided, with the public assuming the company would cease its role as an intermediary at the end of 2008. Yet in early April 2008, it became known that RosUkrEnergo would remain the intermediary.

A new Tymoshenko-Putin meeting in early October brought the renewed hope that Ukraine would start buying gas directly from Gazprom, and that prices would gradually transition to market levels. Such agreements of principle were expected to be firmed up during Naftogaz head Oleg Dubina's expected visit to Moscow on November 11. Yet, due to circumstances which remain unknown, the result of the visit brought exactly the opposite: no agreement, and a hardening of Gazprom's position vis-à-vis Naftogaz, to which it demanded the pay-back of an even higher debt than previously discussed ($2.4 bn, while Naftogaz recognized only $1.3 billion to RosUkrEnergo). As an alternative to immediate payment, Gazprom proposed to Ukraine either to pay the debt in the form of transit services in 2009 ($2.4 bn is equal to 14 months' worth of transit services), or maintain the current scheme involving RosUkrEnergo; Ukraine rejected both options. After that, the situation started to escalate quickly.

This brief overview of events in 2008 tells us that the gas negotiations with Russia had only secondarily to do with prices, and much more with the profitable role of intermediary suppliers. It is sufficient to point out that RosUkrEnergo's profits from the re-export of Russian gas were estimated to be $2.25 bn in 2006, and approximately $2.9bn in 2007.

Even lacking "insider" information, it is possible to conclude that "someone" did not want the agreements to be fulfilled. According to Prime Minister Yulia Tymoshenko, the main culprit was RosUkrEnergo and its associates in Ukraine, in particular the "Party of Regions" members Yurii Boiko, Dmitro Firtash and Serhii Levochkin. According to Boiko, however, the main problem was an intermediary company associated with Tymoshenko (see *Radio Svoboda*, Ukrainian Service, January 13, 2009). Although we lack sufficient evidence to support either Tymoshenko's or Boiko's versions, the ability of such actors to hold Ukraine's energy policy hostage to their rent-seeking schemes is a factor seriously hindering the resolution of the conflict.

The Yushchenko-Tymoshenko Quarrel as a Further Obstacle

Although at the time of the crisis itself Yushenko and Tymoshenko came out with a joint declaration and a common position on the issue and sought not to undermine each other's credibility in public, the longstanding and deep conflict between Yuschenko and Tymoshenko and lack of clearly divided spheres of competence between president and prime minister undoubtedly contributed to the crisis. Throughout 2008, lack of clarity as to who was in charge of negotiations with Russia complicated the situation, and it was hardly surprising that Moscow would not take a decision on gas trade modalities for 2009 until it became clear who the interlocutor would be in Kyiv.

Even more problematic was the difference in policy preferences and interests between the president and prime minister, in particular those concerning the oil company Vanco's right to explore in the Black Sea, and modalities for the return of the Odessa-Brody oil pipeline to its original direction to ship Caspian oil north as opposed to Russian oil south, as it has since 2004. Crucial in each of these confrontations was the fact that in each case Tymoshenko accused the presidential entourage of supporting corrupt plans involving offshore companies – a sign of the growing mistrust between both sides on energy issues.

Such disagreements on energy policy were especially damaging given the fact that 2008 offered some promising prospects that gas relations with Russia could be regulated in a satisfactory manner, and that intermediary companies would be eliminated.

The Need to Enhance Transparency

One conclusion to be drawn from this conflict is the need to enhance transparency. Indeed, corruption and lack of transparency in Ukrainian gas markets has been a major threat to the development of a proactive energy policy in Ukraine. Lack of transparency and the corruption often associated with it has greatly contributed to the "Ukraine fatigue" that has greatly reduced Western interest in supporting Ukraine during crises. Yet as much as the West may like to point fingers at its Eastern neighbors, such as Ukraine, in matters of transparency, much work remains to be done at home. The role of Austrian and Swiss partners in the intermediary companies such as RosUkrEnergo needs to be checked much more thoroughly than it has been in the past.

Yet even more basically, the lack of a fully transparent system of gas trade – typically in the name of commercial secrecy – in Europe and other Western states means we have less to offer Ukraine than it may need in order to deal successfully with the energy challenges facing it. If such issues are not dealt with in a definite manner, there is no guarantee that, no matter what temporary solution may be found for this crisis, a similar crisis may occur before we have even recovered from the cold winter of 2009.

About the author

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Further reading

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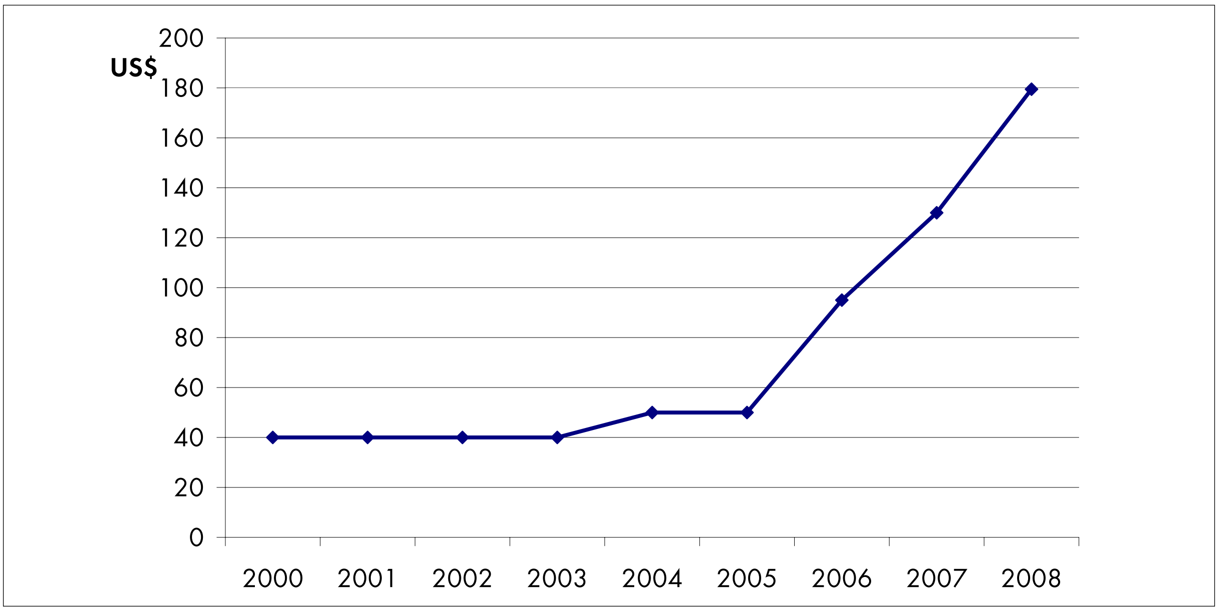
Statistics

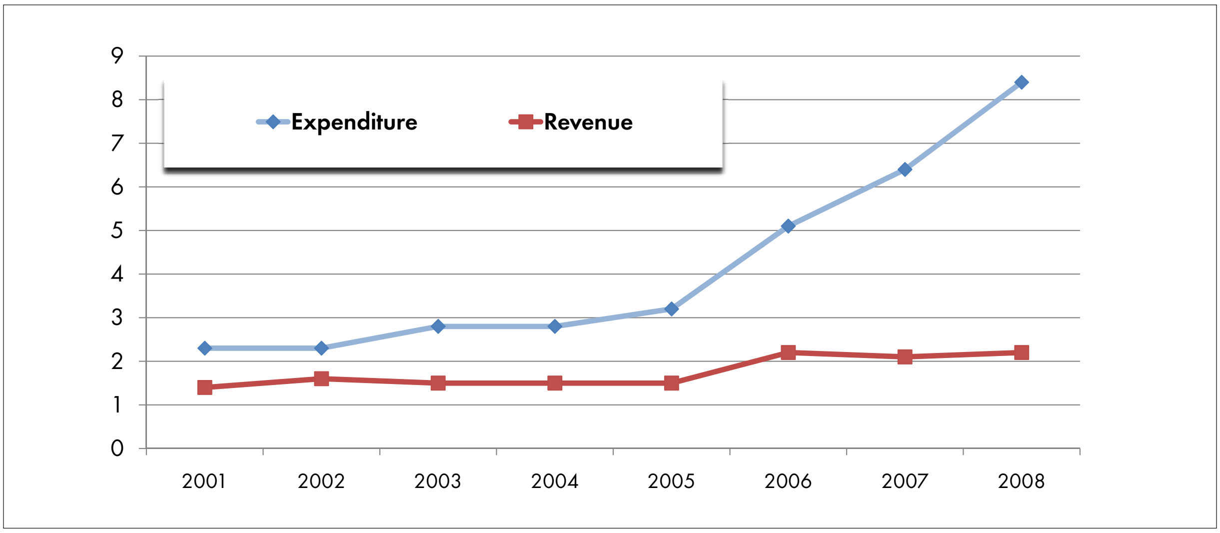
The Russian-Ukrainian Gas Trade

Graph 1: Ukrainian Import Prices for Natural Gas 2000–2008 (US$/mcm)



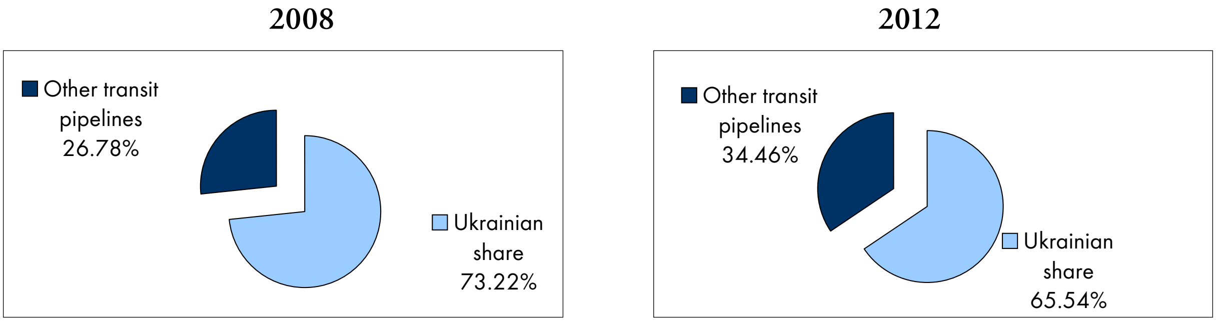
Source: Institute for Economic Research and Policy Consulting, Kiew, http://ier.org.ua/papers_en/v12_en.pdf

Graph 2: Ukrainian Expenditure on Natural Gas Imports and Revenue from Natural Gas Transit (bn US$)



Source: Simon Pirani, Oxford Institute for Energy Studies.

Graph 3: Ukrainian Share of Transit Pipelines for Russian Natural Gas



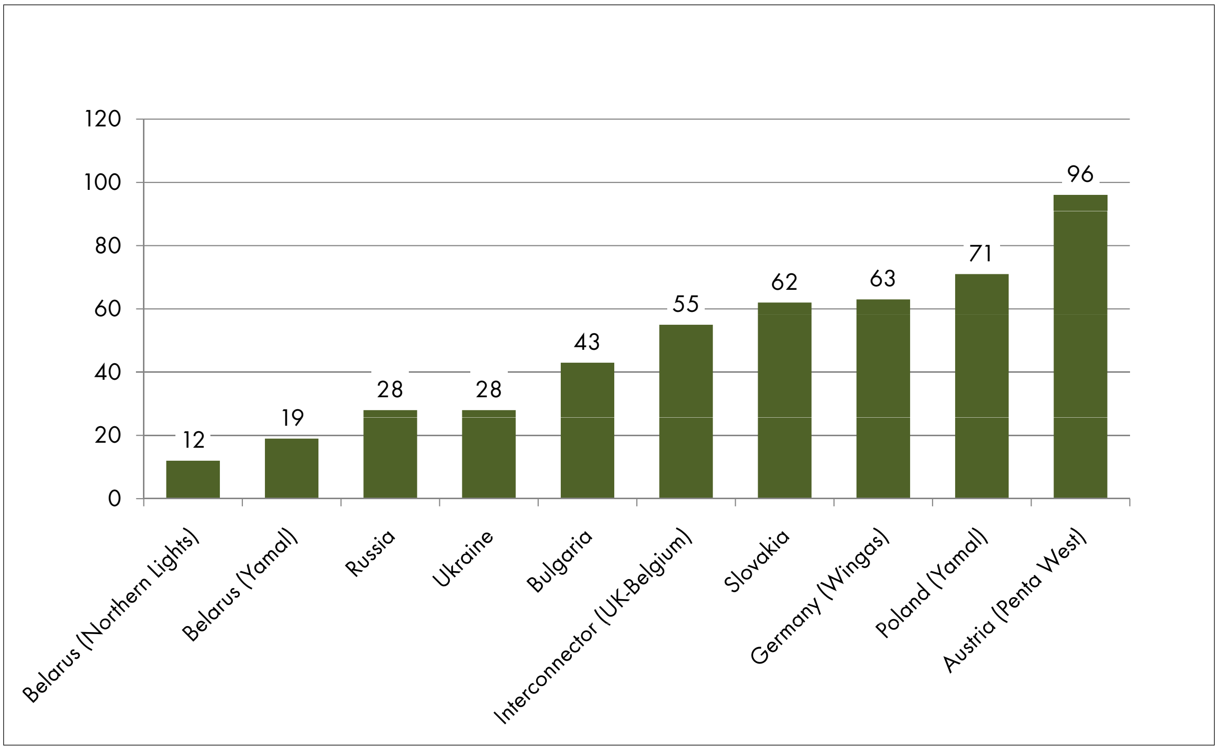
Source: Research Centre for East European Studies, Bremen – own compilation; see Table 1 below.

Table 1: Pipeline Capacities for Russian Natural Gas Exports

Pipeline	Route	Capacity 2008	Capacity 2012
Brotherhood/Union (Soviet network)	Russia – Ukraine – Central Europe	130 bn. cbm	130 bn. cbm
Polar Lights (Soviet network)	Russia – Belarus – Ukraine – Central Europe	25 bn. cbm	25 bn. cbm
Transbalkan (Soviet network)	Russia – Ukraine – Balkans	20 bn. cbm	20 bn. cbm
Finland Connector (Soviet network, extended 1999)	Russia – Finland	20 bn. cbm	20 bn. cbm
Yamal (since 1999)	Russia – Belarus – Poland – Western Europe	28 bn. cbm	28 bn. cbm
Blue Stream (since 2002)	Russia – Black Sea – Turkey	16 bn. cbm	16 bn. cbm
Baltic Sea (NEGP, probably from 2011/2012)	Russia – Baltic Sea – Germany	–	28 bn. cbm
Total		*239 bn. cbm*	*267 bn. cbm*

Source: Research Centre for East European Studies, Bremen – own compilation.

Graph 4: Gas Transit Tariffs in International Comparison (2006, €/m3/350km/h/y)



Note: Tariffs regularly vary according to distance and customer. The graph indicates the average tariff.

Source: Energy Charter Secreteriat: Gas Transit Tariffs in Selected ECT Countries (2006), Brussels 2006, p.65,
http://www.encharter.org/index.php?id=127

Analysis

Europe Held Hostage?

By Kirsten Westphal, Berlin

Abstract

The current Russian-Ukrainian "gas war" caused a complete halt in the delivery of natural gas from Russia, through Ukraine, to Europe. In particular, the conflict cut off South Eastern Europe from natural gas deliveries. Extending more than twelve days, the situation is unprecedented. Europe finds itself a hostage and victim of an ostensibly commercial dispute. Despite its desire to remain on the sidelines, Europe felt obliged to engage in the bilateral conflict and take a position. This article explores the extent of the EU's room for maneuver and the instruments it can bring to bear in resolving the crisis and its original causes. The very nature of the Russian- Ukrainian gas dispute is structural, meaning that its resolution requires European political action to address long-term issues. To be effective, the EU has to tackle the problems constricting its gas imports on different levels: bilaterally with Russia and Ukraine, internally within Europe, and internationally with a host of multinational players. No simple remedy will work, so the EU has to rely on a set of measures and tools that comprehensively address energy, foreign, and economic policies. The need for multilateral energy governance on the continent is more acute than ever. All other measures will become effective only in the medium or long run.

An Unprecedented Gas Cut-off

At first glance, the dispute seemed to be commercial and a repeat of the 2005/2006 clash. However, the results of the current disagreement are much more dramatic and have left EU member states and member states of the energy community in South Eastern and Central Europe without gas deliveries from Russia. Industrial users face severe rationing while residents of Slovakia and the Balkans lack sufficient heating. Even Russia's largest consumers on the continent, Germany, France and Italy, must deal with shortages.

The "gas war" that turned off the taps on January 7, has likewise become a "PR-war," with both sides trying to convince the international community that their actions are justified. Although each side has described many technical details to make its case, key facts remain obscure. What persists though is the international bewilderment about the stubbornness of both sides. That hints at underlying realities and structural problems.

The financial crisis has hit both countries, aggravating the economic side of the struggle. The hard-fought domestic power struggle in Kiev between President Victor Yushchenko and Prime Minister Yulia Timoshenko, particularly over the future role of the intermediary company Rosukrenergo, shapes part of the political dimension. The short-term logic driving the political elite on both sides derives from personal interests, corruption and rent-seeking strategies. The involvement of intermediary companies and other business interests makes it difficult to settle the bilateral Russian-Ukrainian dispute on rationale economic terms. Moreover, the general geopolitical landscape functions as an impediment to "smooth" conflict resolution, as Moscow has no incentive to accommodate Ukraine with a gas delivery agreement. Ukraine took a clear stance in the Russian-Georgian war, appealed to join NATO and left open the future deployment of the Russian Black Sea fleet after 2017, among other points of dispute with its eastern neighbor.

The dispute between Gazprom and Naftohaz Ukrainy grew intense in November–December 2008 over old debts and new prices. By New Year's Eve, no agreement for gas deliveries from Russia to Ukraine in 2009 was in place. The Russian side used this situation as a justification to diminish gas volumes delivered to Ukraine, seeking to send Europe's gas through the pipeline while depriving Ukraine of any flows. In the following days, mutual recriminations resulted in a deadlock, and from 6–7 January on, the gas pipelines went dry. Gazprom cut off the supplies after Prime Minister Vladimir Putin gave the public order to do so. An EU gas monitoring mission that began working on January 11–12 did not achieve the much needed break-through. From January 14 on Russia made several attempts to send 99.2 mcm of gas to the entry point at Sudzha, but Ukraine refused to transport it for technical reasons. An accord was reported on January 17, as a result of bilateral negotiations between the two prime ministers. Whether this deal provides the much needed substantial break-though remains to be seen not only in the short-term but also in the long-term.

The EU's Limited Leverage

Gas deliveries to Europe have been taken hostage in the dispute between Russia and Ukraine, as EU Commission President Jose Manuel Barroso has lamented. Are the EU's hands tied politically as well?

Given the brewing humanitarian crisis in South Eastern Europe, German Chancellor Angela Merkel put forward the idea on January 7 of establishing a monitoring mission composed of European, Russian and Ukrainian experts. The monitors deployed on 11–12 January, but have not brought the conflict to an end so far. Other attempts by the European side to broker an comprehensive deal have failed so far.

Both Ukraine and Russia have lost credibility as being able to supply and ship natural gas. But, once the crisis is over, in the short to medium terms, this loss of reputation will have no real consequences on the actual gas flows from Russia through Ukraine thanks to the geographic and infrastructural realities on the continent: in terms of physical flows, there is no alternative to gas from Russia via Ukraine. Supplies from Russia make up 42 percent of EU-27 gas imports. Gas consumption in Europe will most likely trend upward by one percent a year as Europe replaces coal with gas for environmental reasons, according to the forecasts of the International Energy Agency. European neighbor Russia has the world's largest gas reserves, with more than a quarter of the global deposits. Europe's own reserves are running out, so the two are bound together. Moreover, currently all Russian exports outside the CIS are directed toward Europe. Gas sales to Europe account for the vast majority of Gazprom's income. Moreover, Ukraine is still the most important transit country, as 80 percent of all exports from Russia pass through this former Soviet republic. The existing alternate pipeline routes transport much smaller volumes: the Yamal-Europe pipeline carries only 33 bcm/a and Blue Stream transports just 16 bcm/a to Europe.

Moscow and Kiev may have calculated that situation thoroughly. Even economic losses from unrealized gas sales and transit services are relative. Many European customers have used gas from storage which has to be replaced later (by Russia via Ukraine), presumably at lower volumes, maybe at falling prices. Moreover, Gazprom has declared "force majeure" on the transit issue, claiming that it is not liable for non-fulfillment of contracts and shifting the burden of proof if any of its customers demand penalties. So far, not a single European gas company has announced court action.

In fact, the EU's political and economic leverage is very limited in the short-term. There is no remedy as such, but the EU must put in place a set of measures and tools that together constitute a comprehensive energy, foreign, and economic policy.

The EU Tool Box

When it comes to the "small box" of tools that are related to energy security, EU measures will only have an impact in the medium to long run, that is from five to fifteen years. The need for a prudent and sustainable energy policy is more urgent than ever. Europe has focused on the demand side, concentrating on energy savings, energy efficiency, and diversification of the energy mix with a strong reliance on renewables. This approach builds on the assumption that the cheapest and most secure energy source is the one that is not consumed. And indeed, the European Union has been on the global forefront with its 20+20+20 formula, which calls for reducing greenhouse gas emissions by 20 percent from their 1990 levels, making renewables 20 percent of final energy consumption, and implementing a 20 percent savings in future energy demand by 2020. Implementation of this plan will make a significant contribution to increased energy security in the future. Of course, gas will remain a major energy source for ecological reasons.

In terms of narrow energy security, diversification is the key. The first dimension of diversification concerns the energy mix, which can be broadened by new sources of fuel such as biogas. The other dimension concerns the diversification of supply, requiring new suppliers and alternative import infrastructure including LNG facilities. In that respect, the Southern, or fourth, corridor from the Caspian Sea region and Central Asia has gained prominence in the debate. The current gas war shows that new infrastructure projects are needed and the Nabucco pipeline has already received more support. In contrast, the Nord Stream pipeline project is viewed more critically, mainly because Russia, the only supplier for Nord Stream, plays a prominent role in the current crisis. The Russian leadership has made a major point over the last year that it seeks direct access to European markets.

Both infrastructure projects, however, highlight the incoherence of European energy policy. Despite the fact that both projects have been identified as TEN-E projects, both are delayed in their implementation, and questions about their feasibility abound. Many observers argue that the EU should not only identify strategic transport corridors, but should also improve its own financial and political instruments to realize them. The idea of Brussels as a broker for energy projects which require business consortia at all stages of the project, has been widely discussed, but has yet to be implemented. Still, private energy companies are the main players in implementing supply-side energy security, and they compete with each other in the markets. The competencies of Brussels in respect to energy security are very limited since the EU has no common energy policy so far.

Europe in Search of Solidarity

The gas war is taking place shortly after the EU released its Second Strategic Review in November 2008. This current round of conflict likely will give greater emphasis to certain elements outlined in the document. The EU no longer sees energy security through a geopolitical lens, equating discussions of it with the lack of a common external energy policy. Instead, the EU now focuses on solidarity among the member states and expansion of the internal gas pipeline network, building new storage facilities and improving the exchange of information. In that respect, the gas dispute could push forward the Nord Stream pipeline, but with greater solidarity among member states, a concept that Poland originally proposed in response to the German-Russian deal on the Baltic Sea pipeline. Currently, the solidarity mechanisms that can be used are limited in scope, particularly regarding bidirectional pipeline links and storage facilities. The fact that spot market gas prices in Europe increased by a quarter from December 2008 to January 2009 reflects this problem. With the exception of a more coordinated exchange of information, all other envisaged measures will take time. The EU's list of tasks to be accomplished internally is already large and costly. Nevertheless, its energy efficiency goals should also guide its external policies toward Russia and Ukraine.

In its foreign relations, the EU has to focus on the bilateral issues at stake. The whole gas war reveals the murky gas relationship between Russia and Ukraine, bringing in gas supplies from Central Asia and using intermediary companies. In general, long-term supply gas contracts are among the most secret documents in the energy business. In respect to Russia and Ukraine, the situation is even worse as the principle of *"pacta sund servanda"* is not the underlying rule or culture, so contracts do not have the force of law. The disagreement over debts and prices has resulted in new quarrels about transit arrangements and fees. The EU and its member states have to exert all possible influence bilaterally: Russia and Ukraine must settle the issue in a transparent and stable manner based on contracts.

Building Agreement between Russia and Ukraine

Negotiations over gas prices for 2009 are indeed difficult at a moment when gas prices are about to drop significantly. Russia and Ukraine have agreed that gas prices should gradually increase to European netback levels, that is European gas prices minus the respective transport and transit costs. European gas prices follow a complex price formula that is bound to oil prices with a delay of about six months. This is the reason why it is evidently difficult at the moment to agree on a price. In July 2008, the world saw oil peak at a price of 147 US dollars a barrel – at the moment the price is less than 47 US Dollars. Depending on the reference date, both countries can make an argument for their preferred price. If no clear formula is fixed, the price could be anything from 200 Euros to 450 Euros per thousand cubic meters. Moreover, Russia has locked itself into contracts with Central Asian countries with gas prices of around 300 Euros for Central Asian gas. Simply put, agreeing to a "European price level" is not enough; what is needed is a more detailed formula that can be oriented to the so-called Groningen price mechanisms in Continental Europe. However, other formulas are possible, but they should be comprehensible and not be subject to regular re-bargaining.

In regard to transit issues, the question is how to handle transit fees and transport costs, which have emerged during the dispute, in particular in respect to the technical gas that is needed for the operation of the pipelines. If transit fees should cover technical gas, they should be linked to gas price developments. The transit issues cover the most tricky points in the whole dispute. Russia has tried since the early 1990s to take control via partial or full ownership of the Ukrainian transit pipeline system. The Russians have made such ownership a priority. Ukraine has resisted handing over the pipelines since independence as the pipelines represent a major asset in the yearly quarrels over gas supply volumes and prices, and a source of revenues. A proposed 2002 consortium between the two and involving German companies sought to modernize the trunkline system, but failed to materialize.

The EU Role

In this minefield, the EU has to act very carefully indeed. The EU has already been dragged into the dispute. However, there are several clear choices for transit regimes. Some separate transit fees from fuel costs, and customers on both ends of the pipeline have to pay for both. Other arrangements foresee a payment for "transit" in progressive gas volumes, depending on the actual volume that is shipped though the pipeline. This payment can be either "in kind" (gas itself) or "cash" (that is the actual price of the gas). What makes the Russian-Ukrainian case so difficult is that the regime has to be approved ex post with the whole interwoven transit and domestic pipeline network already in place. However, a clear transit regime is fundamental to solving the structural problems plaguing this major transit route.

Clearly, EU tools to fashion an early success are limited, but encompass first and foremost governance and regulatory initiatives. Nevertheless, critical observers point out that the EU has not invoked any of the institutionalized mechanisms so far. The complete halt of gas deliveries violates Article 7 (on transit) of the Energy Charter Treaty (ECT). Ukraine ratified this treaty, while Russia signed and has applied it, though has not ratified it. Transit issues lie at the heart of a long-term solution for European energy concerns. The EU is right to push negotiations on the Transit Protocol in the EU-Russia energy dialogue and the EU-Russian negotiations on the Partnership and Cooperation Agreement. The full application of this multilateral international regime would install dispute settlement mechanisms. It would be a first step to acknowledge the necessity of a multilateral regime if both sides invoked the conciliation procedure according to Article 7 (7) that the ECT provides.

The bitter fighting surrounding the "gas war" illustrates that structural reforms are needed in the energy sectors of both countries. The need encompasses not only modernization of the transport system and related facilities, which are on average more than 30 years old, but a much more efficient use of energy. This extraordinary potential can only be exploited if leaders demonstrate strong political will and provide financial resources. The EU is the first partner in this respect since it must address the broader economic and political picture but also *Ordnungspolitik* [regulatory politics].

In the aftermath of this unprecedented situation, the EU has to communicate clearly to Russia and Ukraine that this gas cut-off violated all signed bilateral documents, international practice, and the ECT, and destroyed credibility. There should be a full-fledged discussion of the rules, regulations and internationally-binding laws. The EU has put forward the idea of a pan-European energy community. The essential elements of the community are the extension of legal norms and free trade in electricity and gas, together with a harmonized regulation of demand according to the principles of energy efficiency and environmental and climate acceptability. The idea is to enlarge the common market, establish a legal foundation based on shared commercial and ecological norms, and put in place incentives that will tie the states of the Caspian Sea space, the Middle East, and North Africa to the European market by means of new infrastructure projects. And indeed, against the background of the current financial crisis, much needed funds have to come from the West, in particular in the case of Ukraine, but currently also in the case of Russia.

Regarding energy, Russia is the EU's decisive counterpart on questions relating to political order, pipeline routes, and the goal of diversification, since the EU and Russia have different strategies on the central questions of policy. Harmonization of competition, non-discrimination and access to markets, infrastructure, and foreign investment are the central issues that arise, on a regular basis and in a variety of forums. The main bone of contention is Gazprom's transport monopoly. In other words, Gazprom wants to own pipelines outside of Russia, but refuses to let foreign companies or governments own pipelines inside Russia. The EU and Russia are currently negotiating a new Partnership and Framework Agreement. The EU-Russia energy dialogue also provides another bilateral mechanism to negotiate energy issues. These channels have to be used now to address structural issues, such as the early warning mechanisms, which provide the possibility of engaging transit countries as well.

The EU has to put a stronger emphasis on energy infrastructure, but also pressure for more legal certainty in Ukraine. EU-Ukrainian relations are shaped mainly under the EU Neighborhood Policy (ENP) of 2004 and its Action Plans. ENP and other related activities (e.g. Black Sea Synergy) seek to extend the energy community, which came into existence on 1 July 2006 and includes both the EU member states and South Eastern European states, to Moldova and Ukraine and a few others.

What remains is the trivial conclusion that the most secure, cheap and climate-friendly energy source is the one that is not consumed. Estimates of the potential energy savings to be gained in the EU countries are greater than all the gas exports from Russia to Europe, potentially even twice as large. Energy efficiency paves the ground for cooperation. The EU has to put pressure on both countries to focus on efficiency. While the necessary investments will be costly now, they will pay off handsomely in the future.

(Information about the author and suggestions for further reading overleaf)

About the author:
Kirsten Westphal is a researcher at the German Institute for International and Security Affairs (SWP) in Berlin.

Further reading:

- Simon Pirani, Ukraine's gas sector, Oxford Institute for Energy Studies research paper, July 2007.
- Margarita M. Balmaceda, *Energy Dependency, Politics and Corruption in the Former Soviet Union, Russia's power, oligarchs' profits and Ukraine's missing energy policy 1995–2006*, BASEES/Routledge Series on Russia and East European Studies, 2008
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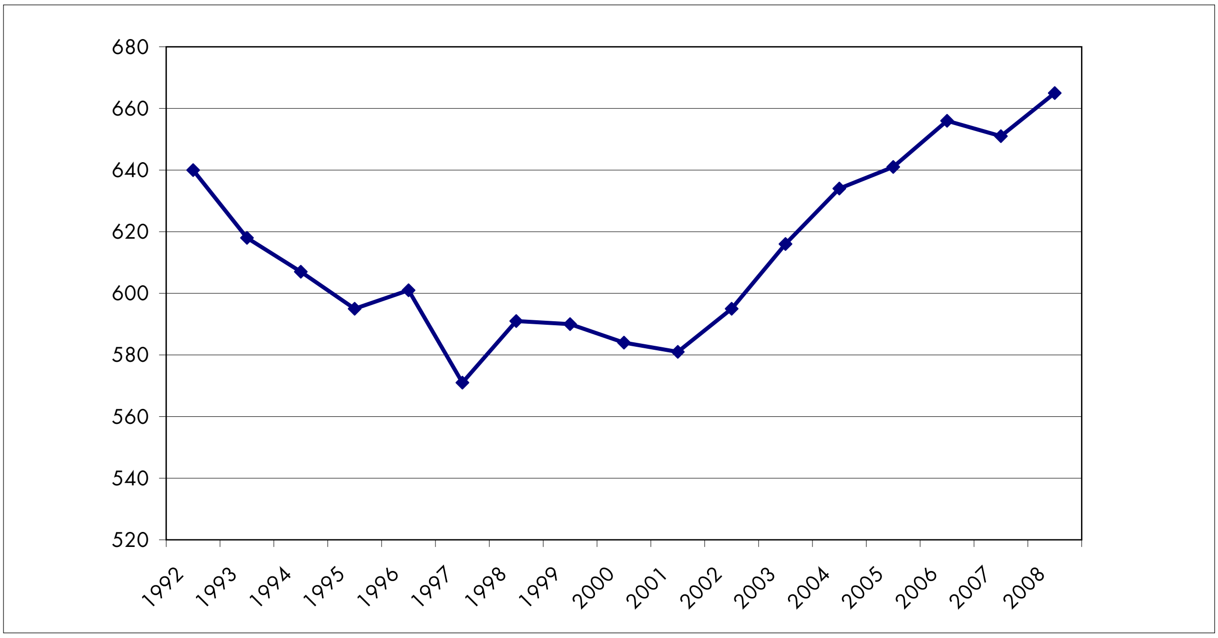
- Oliver Geden, Mehr Pragmatismus, weniger Geopolitik, SWP Aktuell 83, November 2008

Statistics

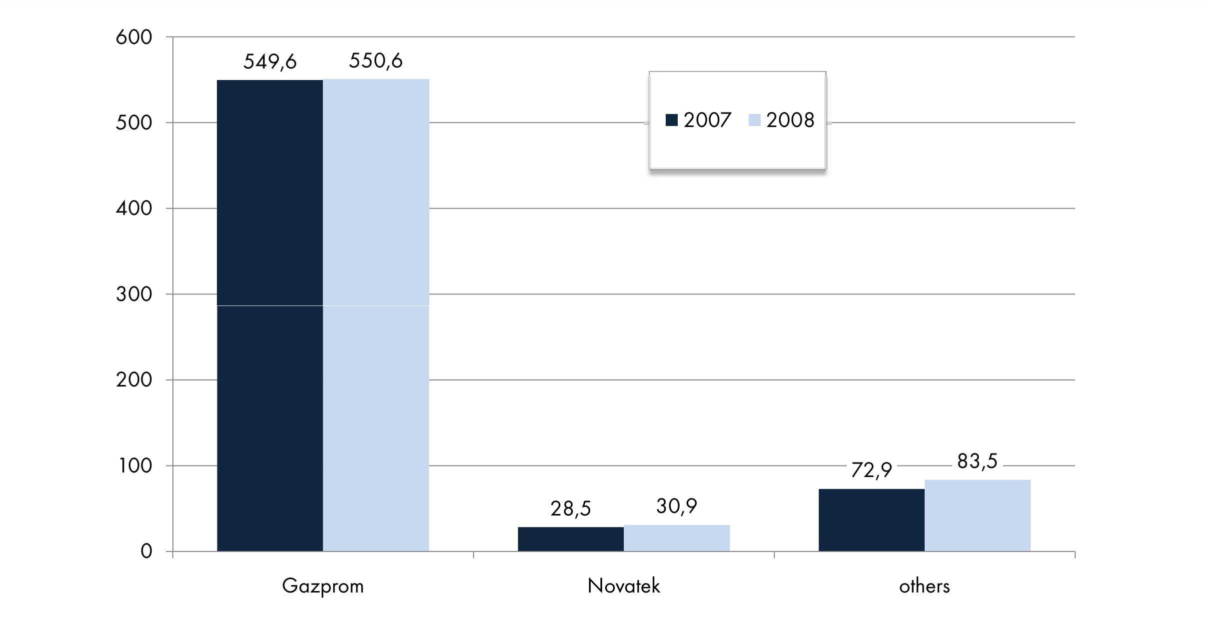
Russia's Natural Gas Industry

Graph 1: Russia's Natural Gas Production 1992 – 2008 (bn cubic meters)



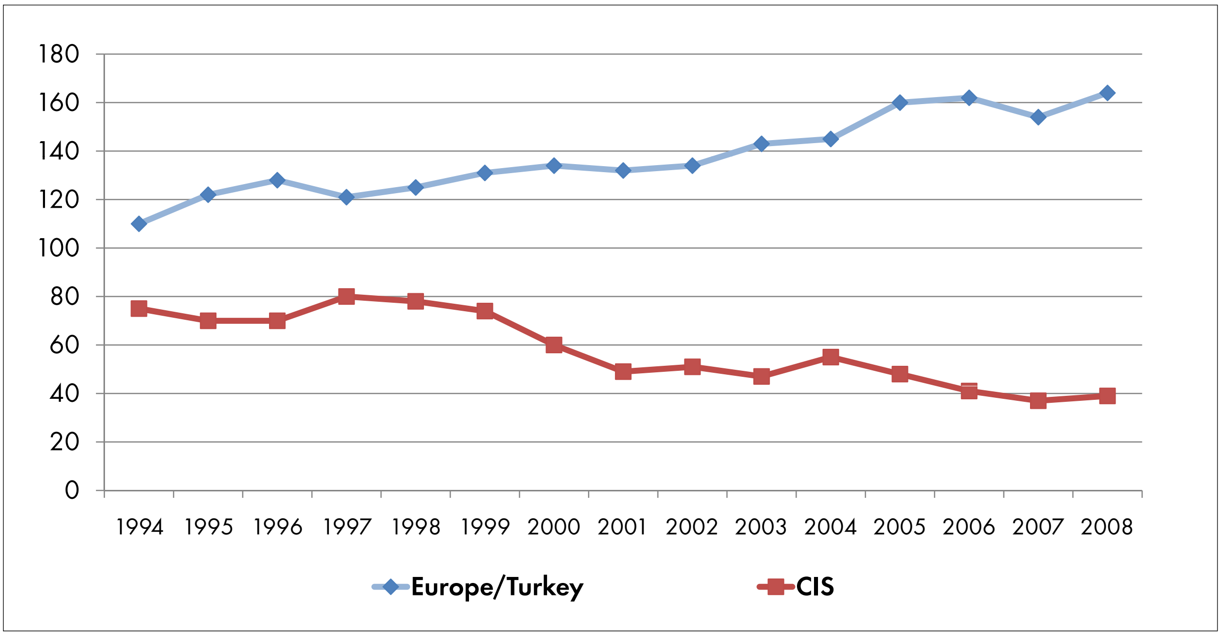
Source: Russian Federal Service for Statistics, http://www.gks.ru/dbscripts/Cbsd/DBInet.cgi

Graph 2: Russia's Gas Production by Company (bn cubic meters)



Source: Company data.

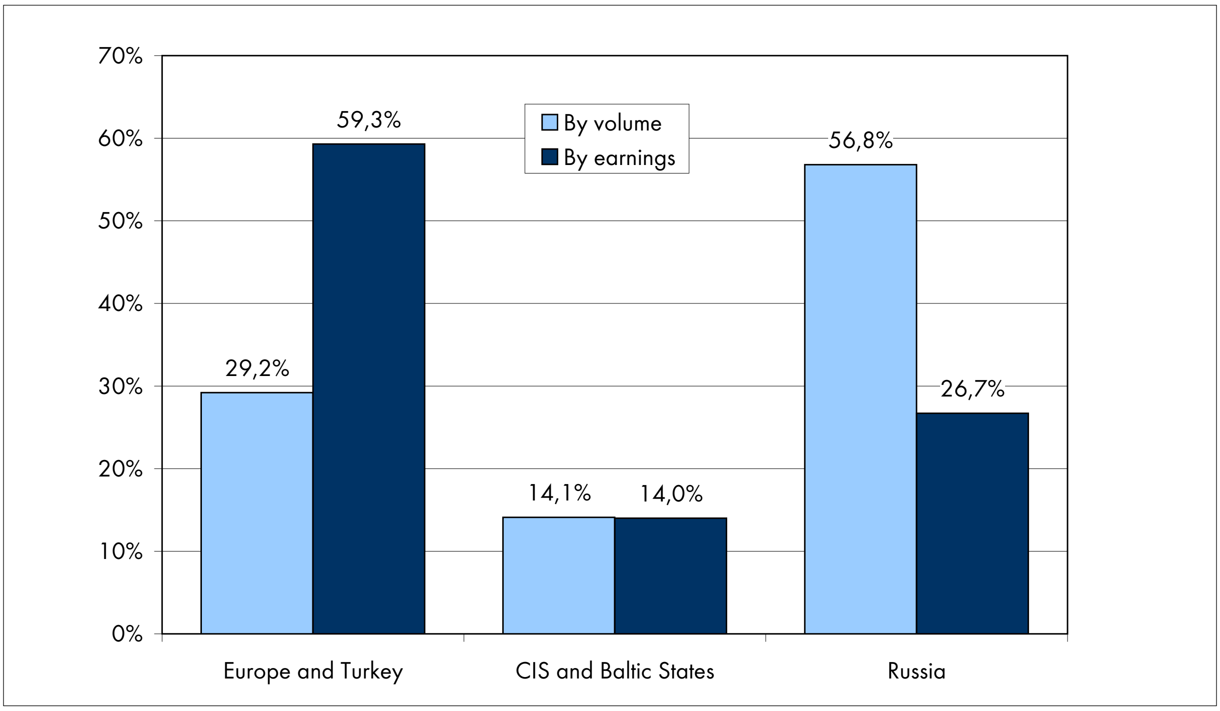
Graph 3: Russia's Natural Gas Exports 1994 – 2008 (Excluding Transit of Gas from Central Asia) (in cubic meters)



Note: data for 2008 are estimated on the basis of data for January - November

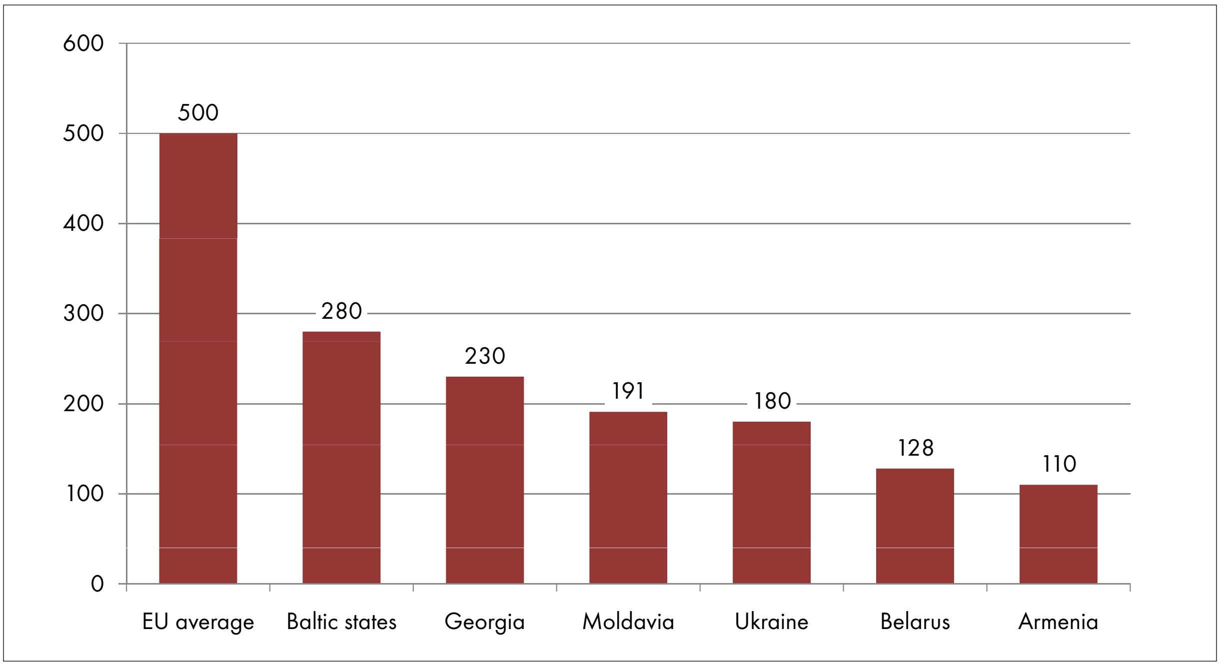
Source: Russian Federal Service for Statistics, http://www.gks.ru/dbscripts/Cbsd/DBInet.cgi

Graph 4: Gazprom's Sales by World Regions (Share in Total, First 3 Quarters of 2008)



Source: Gazprom company data

Graph 5: Gazprom's Export Prices (US$/mcm, 2008)



Source: Energy Information Administration, http://www.eia.doe.gov/emeu/cabs/Russia/NaturalGas.html

Analysis

Background to the Russia-Ukrainian Gas Crisis: Clarifying Central Issues and Concepts

By Margarita Balmaceda, Cambridge, MA

Media accounts and the statements of interested parties often use such terms as "Ukraine's stealing of gas," "Russian's subsidization of Ukraine," and "Gazprom's move to market prices." Often these phrases hinder an accurate understanding of the issues at stake. Thus, it is worth taking a second look at some of these issues and how they play out in today's conflict.

The Debt Issue

Ukraine's debt to Gazprom and other suppliers has been a recurring problem in the relationship since Ukraine's independence in 1991, a problem complicated by issues of state responsibility for private debts, non-repayment of previously restructured debt, and accusations of illegal re-exports and the unsanctioned siphoning of gas. If on the technical side the absence of gas metering stations on Ukrainian territory (all metering stations for incoming gas are located on Russian territory) made it difficult to establish the exact volumes of gas pumped into the Ukrainian pipeline network, lack of transparency and the politicization of the issue have made the situation even more murky. With the debt issue a good cover for corrupt deals, few of the involved actors have been interested in fully clarifying the situation. While Russia and Gazprom have complained loudly about Ukraine's accumulated debt since the early 1990s, such debt provided Russia with a kind of "rain-check" it could make use of when necessary, to be exchanged for political or economic concessions – as it did in 1997 when it persuaded Ukraine to give up most of the Black Sea Fleet in exchange for gas debt forgiveness.

On the Ukrainian side, murky debts played an important role in the system of widespread energy corruption. During Yulia Tymoshenko's tenure as first vice PM in charge of energy, she used the debt issue in her confrontation with rival Ukrainian energy groups, surprisingly announcing that Naftogaz debt to Gazprom actually amounted to over $2 billion, while Naftogaz's management cited a figure much closer to $1 bn. The same story repeated itself in October 2007 as the Rada elections that were to return Yulia Tymoshenko as prime minister were about to take place, and again during the March 2008 "mini-crisis" over the question of who the gas in Ukraine's underground gas storage belongs to. Such differences in debt numbers were especially significant, as each of the Ukrainian rival groups had its own system of connections in Gazprom, which would also be affected by the size of the officially-recognized debt – an "unclear numbers game" clearly benefited top managers at both NAK and Gazprom, as it made it easier to carry out and cover corrupt operations.

In addition, the term "Ukraine's debt to *Gazprom*" does not accurately reflect the situation at the end of 2008, as by definition Naftogaz Ukrainy could not have a debt vis-à-vis Gazprom, as in 2008 the company did not have direct contracts with Gazprom, only with RosUkrEnergo (50 percent of which is owned by Gazprom).

The "Gas Stealing" Issue

Much of Gazprom's media campaign to weaken Ukraine's transit reputation has been based on presenting Ukraine as an unreliable transit partner, and, in particular, on accusations of Ukrainian stealing of Gazprom gas intended for export. Such accusations were a staple of Ukrainian-Russian relations throughout the 1990s and early 2000s. Yet there are many indications that the stealing was not carried out unilaterally by the Ukrainian side. Rather, it can be seen as an example of the confluence of interests between specific actors on the Ukrainian (NAK Naftohaz Ukrainy and its predecessor, Ukrhazprom) and Russian sides (Gazprom). [1]

1 Ukraine's top energy experts, as well as a number of Kuchma-era politicians, have been largely unanimous in confirming the existence of this type of arrangements. See for example Oleksandr Moroz (leader of Ukraine's Socialist Party) quoted in *Gaz i neft´. Energeticheskii biulleten´*, February 13, 2002 (via ISI), Volodymyr Saprykin, interview in Radio Svoboda Ukrainian service "Priamyi Efir," April 12, 2005 17:00 UTC, text available at www.radiosvoboda.org/article/2005/04/69d7a9c5-6fdb-489e-9075 c4ed57a3c7bb9.html (accessed April 14, 2005), Dmytro Vydrin (Director, European Institute of Integration and Development, Kyiv) quoted in "Gazovyi kontsortsium. Otsenki ekspertov," *Gaz i neft´. Energeticheskii biulleten´*, July 16, 2002 (via ISI), Dmytro Vydrin, interview in *Nezavisimaia Gazeta*, November 16, 2000, p. 5, and Yevhen Marchuk, interview in *The Day*, No. 32, November 7, 2000, available at www.day.kiev.ua/266656/ (accessed July 30, 2007).

The Notion of "Market Prices"

Russian commentators have repeatedly used the concept of "market prices" in both the 2006 and the 2009 confrontations, arguing that Russian demands for higher prices for its gas are simply a manifestation of a positive general trend in Gazprom gas pricing policy towards market policies and away from the politicization of energy relations. Gazprom has repeatedly argued it will charge Ukraine "market prices," presented as either "average European prices" or "German prices minus transport costs." Leaving aside the fact that in the course of the confrontation with Ukraine the prices Gazprom quoted and demanded changed repeatedly, "market" gas prices are very hard to determine given the absence of a single worldwide gas market similar to that existing in the case of oil; moreover, the confidentiality of commercial contracts with European importers makes it very hard to clearly establish the average prices. The time lag involved in conventional gas pricing formulas makes things especially complicated at a time of sharp fluctuations in oil prices, on which such formulas are loosely based: while in most EU cases prices are adjusted monthly and thus can adapt, albeit with a lag, to changing oil prices, in the case of Ukraine, prices are set once a year covering the whole year, making the oil quotation at the time of the initial negotiations especially crucial.

Moreover, if we understand "market prices" as prices arising from the meeting of competitive supply and demand, we can easily see that this condition does not obtain in Russian-Ukrainian gas trade, as Ukraine is faced with a single monopoly supplier. Finally, despite all the talk about moving to "market" gas prices across the board, Gazprom continues to set gas prices politically, as can be seen by broad differences in prices charged to post-Soviet states in 2008: from $110/mcm charged Armenia and Belarus, to $278.71 for Moldova.

The "Subsidization" Issue

As the confrontation escalated, Russian PM Putin presented the accusation that, in the last years, Russia had "subsidized" Ukraine to the amount of $47bn, mainly in the form of lower-than market prices for gas. This effective sound-bite, however, does not reflect the complexity of Ukrainian-Russian relations since 1991, which make it extremely hard to calculate any such "subsidization." The first problem is that much of the gas trade until 1997 took place on the basis of barter, making it extremely easy to manipulate effective prices through barter coefficients and transactions involving multiple exchange rates. Moreover, a full picture of any subsidization would not be complete without a consideration of Ukrainian services provided to Russia, in particular its de facto subsidization of Russian gas exports to Western Europe. This has taken place through transit and underground gas storage prices much lower than those prevalent in EU countries. Cheap access to gas storage has been especially important for Gazprom, as it has allowed the company to "park" its gas in Ukraine, to be sold to EU users at peak demand periods for higher prices.

Reading Tip

Caucasus Analytical Digest

We are pleased to announce a new online publication: The Caucasus Analytical Digest (CAD). CAD is a monthly internet publication jointly produced by the Heinrich Böll Foundation in Tbilisi (www.boell.ge), the Research Centre for East European Studies at the University of Bremen (www.forschungsstelle.uni-bremen.de), the Jefferson Institute in Washington, DC (www.jeffersoninst.org) and the Center for Security Studies (CSS) at ETH Zurich with support from the German Association for East European Studies (DGO). The Caucasus Analytical Digest analyzes the political, economic, and social situation in the Southern Caucasus within the context of international and security dimensions. Subscription is for free.

You are welcome to subscribe to the CAD mailing list at www.res.ethz.ch/analysis/cad

About the Russian Analytical Digest

Editors: Matthias Neumann, Robert Orttung, Jeronim Perović, Heiko Pleines, Hans-Henning Schröder

The Russian Analytical Digest is a bi-weekly internet publication jointly produced by the Research Centre for East European Studies [Forschungsstelle Osteuropa] at the University of Bremen (www.forschungsstelle.uni-bremen.de) and the Center for Security Studies (CSS) at the Swiss Federal Institute of Technology Zurich (ETH Zurich). It is supported the German Association for East European Studies (DGO). The Digest draws on contributions to the German-language Russlandanalysen (www.laender-analysen.de/russland), the CSS analytical network on Russia and Eurasia (www.res.ethz.ch), and the Russian Regional Report. The Russian Analytical Digest covers political, economic, and social developments in Russia and its regions, and looks at Russia's role in international relations.

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Research Centre for East European Studies [Forschungsstelle Osteuropa] at the University of Bremen

Founded in 1982, the Research Centre for East European Studies (Forschungsstelle Osteuropa) at the University of Bremen is dedicated to socialist and post-socialist cultural and societal developments in the countries of Central and Eastern Europe.

The Research Centre possesses a unique collection of alternative culture and independent writings from the former socialist countries in its archive. In addition to extensive individual research on dissidence and society in socialist countries, since January 2007 a group of international research institutes is participating in a collaborative project on the theme "The other Eastern Europe – the 1960s to the 1980s, dissidence in politics and society, alternatives in culture. Contributions to comparative contemporary history", which is funded by the Volkswagen Foundation.

In the area of post-socialist societies, extensive research projects have been conducted in recent years with emphasis on political decision-making processes, economic culture and the integration of post-socialist countries into EU governance. One of the core missions of the institute is the dissemination of academic knowledge to the interested public. This includes regular email service with nearly 20,000 subscribers in politics, economics and the media.

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The Center for Security Studies (CSS) at ETH Zurich

The Center for Security Studies (CSS) at the Swiss Federal Institute of Technology (ETH Zurich) is a Swiss academic center of competence that specializes in research, teaching, and information services in the fields of international and Swiss security studies. The CSS also acts as a consultant to various political bodies and the general public.

The CSS is engaged in research projects with a number of Swiss and international partners. The Center's research focus is on new risks, European and transatlantic security, strategy and doctrine, state failure and state building, and Swiss foreign and security policy.

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The CSS runs the International Relations and Security Network (ISN), and in cooperation with partner institutes manages the Comprehensive Risk Analysis and Management Network (CRN), the Parallel History Project on NATO and the Warsaw Pact (PHP), the Swiss Foreign and Security Policy Network (SSN), and the Russian and Eurasian Security (RES) Network.

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