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# Dispute between Russia and Ukraine settled? – Strategies for the European Union to get out of the gas trap

*Readers of the headlines that recently made it to Russian newspapers described them with the following play of words: It was either the "sektor Gaza" (the Gaza Strip) or the "sektor bez gaza" (the region without gas). At least the gas dispute between Russia and Ukraine seems to be solved for the moment, after Russian prime minister Vladimir Putin and Ukrainian prime minister Yulia Tymoshenko have agreed on a solution on January 18. The event has once again pushed the diversification of energy supply in the European Union to the top of the agenda. However, there is more to be done. The EU should use its influence on the Ukrainian government to help it reduce its own demand of natural gas and assist it at improving its energy infrastructure.*

The public, by now, perceives the gas dispute between Russia and Ukraine as an annual event. At a time when temperatures in the whole of Europe seldomly reach more than zero degrees Celsius the clash between the Russian gas company Gazprom and its Ukrainian counterpart Naftogaz directly affects the European Union and South East European countries. Bulgaria and Slovakia, for example, had to shut down public facilities, like schools, because they are no longer able to heat them. Both countries are thinking about reactivating their nuclear power plants that they recently had to shut off in order to fulfil the conditions of EU membership. But also non-EU member states like Bosnia-Herzegovina or Serbia suffer from the lack of gas. Families from cities move to their relatives in the countryside because they use coal heaters. As a consequence, those countries are beginning to suffer from a shortage of coal as well. Meanwhile the debate on the dependency on Gazprom and its rigid business practices is once again emotionally discussed in the Western media.

## The dispute has an economic and political dimension

Almost 80 percent of the Russian gas deliveries to Europe flow through Ukrainian territory. Furthermore, about 75 percent of the Ukrainian gas imports come either from Russia or from Central Asia, which is in turn supplied through Russia. Despite its own gas production, which amounts to not more than 30 percent, Ukraine is highly dependent on Russia. The energy supply of Europe is therefore dependent on bilateral and even multilateral relations and therefore subject to international politics. Although the issue has become highly politicized, it started as an economic dispute between Gazprom and Naftogaz when the Russian company demanded an immediate settlement of the debts in November 2008. It would be wrong to assume that the gas dispute has only escalated due to the intentions of the Russian administration to overthrow the current government of Ukraine or to punish it for its ambition to become a NATO member. One of Gazprom's interests as a company is – and has to be – to sell its products to market prices. When it comes to the analysis of the crisis, the economic dimension should therefore not be neglected.

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In every country of the former Soviet Union the prices for natural gas from Russia are below the market value. This allows the countries a softer transition to market prices, but it also enables Russia to use the energy supplies as an instrument to gain influence on the countries in its neighbourhood. While all other natural resources are traded at fair market value between the Russian Federation and Ukraine, gas remains the last resource to receive this intransparent subvention. By selling subsidised gas to Ukraine, Gazprom had lost revenues of approximately $12 billion in 2008 compared to the prices for the European trade partners. Although Gazprom is gradually reducing the – to some extent extreme – divergence between the value of the gas delivered and the price paid for it in the post-Soviet states, this process is undergone in different paces and to different conditions. But these do not necessarily reflect the relations between the Kremlin and the respective governments. In December 2006, the dispute between Russia and Belarus on gas prices and transit fees led to a temporal termination of the Druzhba-pipeline, the world's longest oil pipeline, which supplies around 20 percent of Germany's oil. Ironically, the translation of the pipeline's name is "friendship", reflecting the good political relations between Moscow and Minsk. However, even in this case, the economic interest was more relevant than the friendship between former Russian president Vladimir Putin and his Belarusian counterpart, Alexander Lukashenko.

Besides Belarus, Armenia is the country among the former Soviet republics that pays the lowest price for Russian gas. The price is fixed at $119, respectively $110 per 1000 cubic meters (cbm), and in return Gazprom is having a stake in their national gas net. A similar model was offered to Ukraine, which, however, declined to sell its gas net to Gazprom. In turn the gas price for Ukraine has gradually been increased from $50 in 2005 to $179.50 in 2008. Naftogaz rejected the offer of $250 for the current year and was only willing to pay a maximum of $235, a price it is most likely not able to pay either. For the tattered Ukrainian economy, the price of $179.50 has already been too high. In the course of the dispute Alexey Miller, CEO of Gazprom, offered to Naftogaz a price of $450, which is above the price that Western Europe pays with about $418, and far above the expected market price for 2009 that will, according to experts, range between $260 and $300. The gas price is connected to the oil price, and since the global financial crisis led to a rapid decline of the price per barrel oil that temporarily went below $50, the gas price is also going to drop.

> "There is a disproportionate use of natural gas in Ukraine in relation to its economy. Having an economy the size of the Czech Republic's, Ukraine uses as much gas as the Czech Republic, Slovakia, Hungary and Poland together."

## Intransparent Middlemen and inefficient use of energy

Another problem related to the gas dispute between Gazprom and Naftogaz is the interconnected Ukrainian middleman. The current company is RosUkrEnergo (RUE). Similar to its predecessors Itera and EuralTransGaz (ETG), RUE did not have to apply for this profitable position. Ukraine pays RUE with around 20 percent of the total delivered gas in kind, having received $4.35 billion worth of gas in 2007, assuming an average gas price of about $300 per 1000 cbm. Officials of the Russian and Ukrainian gas industry are directly profiting from this bargain. Outsiders can neither reconstruct who is responsible for these deals, nor how the actual gas price and transit fees come about. The unclear responsibilities lead to the chronic underinvestment in the infrastructure of the gas sector in Ukraine. As a result, a gas pipeline near Kiev exploded due to a lack of maintenance in May 2007.

In addition to this problem, there is a disproportionate use of natural gas in Ukraine in relation to its economy. Having an economy the size of the Czech Republic's, Ukraine uses as much gas as the Czech Republic, Slovakia, Hungary and Poland together. That makes Ukraine the sixth biggest consumer of natural gas in the world. Reasons for this are the cheap gas price that Ukraine offers to the consumers at home and the inefficient use of energy. Thermal isolation is still the exception in Ukrainian households.

## Homemade problems in Ukraine

Ukraine has manoeuvred itself into a difficult position lately. Naftogaz knew that the gas contract with Gazprom would run out at the end of 2008, but failed to take early actions. The debts of about $2 billion dollars have not completely been amortised. Shortly before the end of December 2008, Ukraine paid $1.5 billion to Gazprom. The Russian company considers the outstanding $0.5 billion a penalty for failure of payment by Naftogaz. This was one of the initial arguments between both parties, as mentioned above. Moreover, Ukraine was accused of siphoning off gas from the deliveries to Western Europe. According to Gazprom and a Swiss monitoring company, something similar had happened during the last gas dispute in 2006. Even though Ukraine uses its own gas and the cheaper gas from Turkmenistan to supply its population, delivery bottlenecks force Ukraine from time to time to use Gazprom's gas and therefore debts are increasing. The alleged siphoning led to the termination of all gas deliveries to Ukraine, and consequently to Western Europe, by Gazprom.

Naftogaz is also to blame for the repeated shutdown by Gazprom. A certain amount of gas is needed in order to be able to keep a pipeline running. According to Naftogaz, Gazprom should provide this so-called transitional gas. Gazprom's standpoint, however, is that Naftogaz should buy the transitional gas, which was declined by Naftogaz. The political relations between the Russian administration and their Ukrainian counterparts have been strained since the Orange Revolution in 2004. However, not even the best friends would make deals between their companies about the delivery of a product without a contract and with a price to be fixed in the future. This is particularly not the case when the buying company additionally has debts with the company that is selling the product.

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At the end of the day Gazprom simply needs to ensure its profits, and therefore has a strong interest in getting paid for its gas. It wants to get paid for the debts by Ukraine, get paid for gas deliveries to Ukraine at a fair market price, and get paid by Western Europe. Because no gas flew through Ukraine to Europe Gazprom lost around $120 million every day. With respect to market prices in decline and the global financial crisis, Gazprom cannot afford to set revenues aside as well; it was therefore also interested in finally settling the dispute.

### The role of the European Union

The current Czech presidency was able to mediate an agreement between Russia and Ukraine on the deployment of a monitoring mission in order to control the gas pipelines that cross Ukraine. Although some commentators have criticized that the EU negotiators were not able to apply more pressure on Russia and Ukraine to overcome the conflict faster, it should not be forgotten that the mediation between both countries was a rather difficult task. The debate between Kiev and Moscow was also about the "multilateral" composition of the mission. Ukraine rejected the idea of representatives of Gazprom as participants in the mission and wanted monitors only from the European Commission. While the EU monitors were already on the ground in Ukraine, Russia insisted that the inclusion of Russian officials in the mission was a prerequisite to restore the gas supplies. Just as problematic was the fact that the agreement had to be signed again by both parties after the one-handed addition of annexes by Ukraine, declaring that Naftogaz has no debts with Gazprom. In the end, the mediated agreement was a compromise and allowed the Ukrainian, Russian, and European observers in the mission to enter Russian and Ukrainian territory. Although the monitoring mission never started its work, the EU nevertheless achieved both parties continuing the negotiations and finally reaching a breakthrough.

While many observers in the run-up to the presidency did not have much confidence in the Czech government, it did a fairly good job in the mediation process between Russia and Ukraine. The liberal prime minister Mirek Topolanek and his government showed a good understanding of Russian problems and proved to be fast and good EU negotiators. It is also said that the German chancellor Angela Merkel played a crucial role in the mediation behind the scenes. Both conflicting parties perceived the EU as a neutral mediator. Thus, the issue was also an opportunity to put Europe's strained relations with Moscow back on course.

### Ways out of the gas trap

In order not only to be able to strengthen its role towards the Russian Federation but also to prevent any future gas shortage in Western Europe, the EU should take the following steps:

1. As a short-term goal the EU needs to agree on effective mechanisms to prevent the total shutdown of gas supplies through Ukraine in the future. One possibility would be to use its influence on the Ukrainian government to help it mediate conflicts with Russia before they escalate.

2. By helping to build confidence between Ukraine and Russia, the EU also improves its relations with Russia. Energy security issues need to be addressed in the new Partnership and Cooperation Agreement (PCA) between both parties. Legal regulations will not only prevent Europe from freezing but also help Russia to restore confidence in being a reliable energy supplier.

3. The EU should assist Ukraine in its efforts to guarantee the functioning of its gas net. One possibility would be to create an international consortium,

which would rent the Ukrainian gas infrastructure. This would relieve Ukraine of the burden to invest in the infrastructure.

4. Ukraine also needs assistance in order to establish a more efficient energy infrastructure. Being the sixth largest consumer of natural gas in the world, Ukraine furthermore needs to diversify its energy sources. However, this should not solely be achieved by focusing on nuclear and coal power, as it is proposed in the Ukrainian energy strategy. The EU must now get more active in assisting Ukraine to invest in alternative energy sources as well. This is an issue Ukraine would have to address in the future anyway if it wants to achieve EU membership one day.

5. However, not only Ukraine but also the EU itself needs to continue to search for alternative sources of energy. Only combined efforts of all member states will be successful and sustainable in this respect. Therefore the call for an integrated energy policy has to be iterated. National efforts once again stood out to be inefficient and insufficient. The EU has to ensure that its energy networks are better integrated and inter-connected, and should strengthen the internal market in gas and electricity.

6. Furthermore, the establishment of alternative routes of energy are certainly another way of preventing the shortage of gas supply in Western Europe. In addition to the construction of alternative routes from Russia, like the North and South Stream pipelines, the EU should particularly focus on alternative energy routes from third countries in order to reduce its dependency on Gazprom. The Nabucco pipeline from the Caucasus should become the top priority, while at the same time thinking of additional options, for example the promotion of liquid natural gas (LNG).

The Czech government, which has formulated energy as one of the priorities during its presidency, has now a good reason to continue its efforts in this policy field. Not all of these recommendations can be implemented in such a short period of time. However, the Czech presidency should try using this opportunity to take the first steps on the way out of the gas trap. Progress in the sektor bez gaza was definitely easier to achieve as in the sektor Gaza. In the end, many commentators might be surprised by the successes of the Czech presidency.

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