

UKRAINE, RUSSIA AND ENERGY

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Twice within the past five months, the inevitable has provoked surprise. When Russia's Gazprom halted its daily delivery of ninety million cubic meters of gas to Ukraine on January 1, Europe's political leaders were marginally less astounded than they were by the outbreak of conflict in Georgia in early August. But as in August, the dynamic of escalation has caught them completely off guard. Keeping control of a European energy policy requires a much smarter game.

Final Warning

eVEN AS THE RUSSIAN GAS CUT-OFF BEGAN TO affect European supplies, the new Czech presidency nearly wrote the European Union out of the script, terming the 'commercial dispute' on January 2 a 'bilateral issue between two countries'. But four days later, the day after Prime Minister Vladimir Putin took the first steps to halt all supplies across Ukraine's gas transport network to Europe, the EU had come almost full circle. By January 10, it had secured Russian and Ukrainian signatures to an agreement to resume gas supply to external customers and had despatched EU monitors to gas transit points. Yet despite this activity, there is still no gas supply agreement between Russia and Ukraine themselves. And in Europe as a whole, it is far from clear that the sources, dynamics and implications of the dispute are understood.

Who, after all, has been paying attention? The global

financial crisis has created a new universe of uncertainties and pressures for European governments. These governments, like ordinary citizens, are also creatures of habit.

The 2006 Russia-Ukraine gas crisis was resolved in the most inauspicious manner. But it was resolved. Russia's three-day gas supply cut to Ukraine last March did not affect European supplies. So it was forgotten. Moreover, the global financial crisis is now Russia's crisis, too, and that fact – which not even Putin any longer denies – was supposed to moderate Moscow's behaviour, was it not?

THEN AND NOW

For four reasons, the current crisis is different from those that preceded it.

First, as Pavel Baev has noted, Moscow has launched this gas war 'out of desperation rather than arrogance'; though, as





in all Russia's dealings with Ukraine, arrogance must be given its due. Russia's stock market lost over seventy percent of its capitalisation between June and October, the price of oil has dropped from \$147 to \$48 a barrel, and Gazprom has been bailed out from state coffers after the value of its shares declined 76 percent.

The structural deficiencies of the energy sector that were not addressed in times of plenty cannot be addressed in these circumstances, which must in turn raise fresh doubts about the viability of Nord Stream and South Stream: the two flagship joint-venture pipeline projects, including Gazprom, designed to knock Ukraine out of the equation for deliveries to Europe.

Gazprom, then, needs money, and it therefore seeks to lock Ukraine into a contract before the price of gas drops precipitously. Moreover, if prospects recede of bypassing Ukraine's gas transit system – which supplies Europe with eighty percent of the gas it imports from former Soviet states – then the imperatives of controlling that system increase. If Ukraine cannot pay with money, then let it pay with assets.

Finally, if the bypass projects are to be revived, Europe will need to be persuaded that Ukraine's gas transit system is a threat to its own security, not just Russian ambitions, and in recent days Russian political and energy figures have begun to say this loudly.

Russian experience suggests that if you push on several doors at once, something might give way. Desperation has

given Moscow a set of goals, and it might even create opportunities. But for now, the dispute is proving at least as damaging to Gazprom as to its customers.

The second difference, which only aggravates the first, is that European pricing, the principle justifying the 2006 cut-off, no longer operates in Russia's favour. True, according to the well established Baumgarten formula, gas prices lag behind oil prices by six-to-nine months. Despite this, Gazprom's end of year offers were in keeping with the October memorandum between Ukrainian Prime Minister Yulia Tymoshenko and Putin, envisaging a staged transition to full European pricing by 2011.

By the end of last year, Gazprom had offered to raise Ukraine's gas price from \$179.50 per thousand cubic meters to only \$250 – versus a \$400-plus EU average – and were even willing to consider \$230 with a modest increase in Ukraine's transit fees, which are currently one-third the EU average.

But when the Ukrainians temporised, everything turned upside down. Gazprom abruptly annulled the October agreement, presented Ukraine's negotiators with a take-it-or-leave-it offer of \$418 and cut off supply. Had it stuck to \$230-\$250, Russia would have gained considerable credit, and Ukraine would have found itself completely isolated in Europe.

The transit issue has now put the dispute, and Russia, in a completely different light. A brief cut-off of Ukraine's normal deliveries would have fitted the textbook pattern of 2006 and last year and shocked the negotiating process back to life. Enter Putin, and a careful, calculated policy designed to maximise diminishing returns becomes an exercise in vengefulness and punishment. This loss of perspective, ominously reminiscent of the Georgia conflict and the recognition of South Ossetia, had by January 7 led to a complete halting of Russia's deliveries across Ukraine to Europe.

This has nullified the third difference: Russia's extraordinary investment in public and governmental relations. In contrast to 2006, Russia's representatives put a clear and compelling case and kept EU governments well informed. In the first few days of January, they sustained a rolling narrative about Ukraine's diversion of gas intended for Europe and kept the focus squarely on Ukraine's unreliability as a transit country. In this enterprise, Ukraine has done everything possible to help.

Few industry experts in Europe accepted Kiev's claim that the diversion of gas for 'technical reasons' could account for the shortfalls of deliveries. European consumers began to experience. Yet by January 6, it had become clear that Russia was making wholesale cuts to gas earmarked for the European market. The meaning was equally clear: 'blaming Ukraine' matters more to Russia than meeting its obligations to Europe.

The fourth difference is that Russia is far stronger in the region than it was in 2006. For the foreseeable future, NATO

enlargement is dead in the water. The EU's undoubted apprehensions about Russia make it more inclined to conciliate than confront it.

Ukraine's infirmities are substantially greater than they were three years ago. Its political crises arise at ever shorter intervals, its economic crisis is assuming perilous proportions, and the EU has steadily lost patience with a leaderless country whose vulnerabilities are largely self-induced.

As to the EU's own vulnerabilities in the sphere of energy security, the Commission's Energy Policy for Europe and the Council's Action Plan, anyone can see that much has been said and next to nothing done. The United States is preoccupied with itself, in presidential transition and far away.

Thus, as with Georgia in August, apprehension, resentment, muscle and guile have combined to assault the coordinates of the problem: to destroy Ukraine's reputation as a transit country, to assume control of its energy sector – and thereby much else – and persuade Europe that Russian pipelines and energy dominance are the key to long-term stability. These are dangerous objectives, even if they fail.

THINKING AND ACTING

The beginning of wisdom is to understand that Russia and Ukraine are incapable of resolving the dispute on their own. Ukraine has no capacity to do so. Russia is in no mood to. The culture of the relationship exacerbates every hidden and overt tension. When Russians have the upper hand, they seek final solutions and closure. When Ukrainians face problems, their natural response is to temporise, deliberate and manoeuvre. This is not a culture of understanding at the best of times.

These are not the best of times. Since 2004, the year of the Orange democracy revolution in Ukraine, Putin has lost his proverbial cool. Ukraine's division of power puts gum in every machine. Neither is it a time for the west to adhere to a 'rational actor' approach about where Russia is going.

It would be equally unwise to underestimate the dangers if the dispute is not brought to a swift conclusion. These are not confined to turmoil in EU markets. Today, as opposed to October, Ukraine might find it impossible to meet the terms that Russia finds acceptable. Whilst it buys gas in US dollars, internal sales are conducted in hryvnya, whose value has fallen from 4.9 to the dollar in September to 7.6, and unofficially lower.

On top of the economic crisis – which has the capacity to politicise anger by itself – a prolonged energy crisis could push the country's infirm institutions and sorely-tested civic disciplines to breaking point. National egos and tempers have breaking points as well.


Given these dangers, the EU will need to find its bearings swiftly. First, it must express outrage at the fact that by suspending supplies of gas for the third time in as many years, Russia has acted in defiance of the Energy Charter Treaty, which, with remarkable gall, it insists the EU enforce against Ukraine. Russia cannot be allowed to forget that, whilst it has not ratified the Treaty, it has signed in a form binding until ratification.

The EU can no longer ignore a legal obligation because Russia refuses to be bound by it. To speak of energy partnership when its first rule is broken invites contempt, not respect. The EU will have no influence in Russia or Ukraine until it gains respect.

Second, it must insist that a stable Russia-Ukraine energy relationship is an important component of European security. To this end, long-term contracts must be concluded on the same pattern that exists between Russia and any EU member state: a European pricing formula, with stable, transparent provisions, price adjustment mechanisms and procedures for arbitration and enforcement. Adherence to the notoriously untransparent, post-Soviet pattern – and preservation of opaque intermediary structures like RosUkrEnergo – will affect the EU-Russia/EU-Ukraine relationship across the board.

Third, it must leave Kiev in no doubt that its grotesquely opaque and dysfunctional energy sector is a threat to Ukraine's own security and that of its neighbours. It should make available finance and expertise to have the system audited and, by stages, made profitable, energy efficient and investor friendly.

Through the Joint Working Group on Defence Reform, NATO and Ukraine addressed an equally daunting challenge in Ukraine's defence sector over a ten year period, and the model should be applied to energy. European perspectives and energy sector reform should be synonymous.

Finally, the EU must put its own house in order and implement steps long agreed in principle. If not, we will soon find that energy policy is made for the  EU rather than by it.

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