

## Europe's Gas Crisis

Last month's Russian-Ukrainian gas struggle should not have caught anyone by surprise. Both have consistently clashed over the gas trade since the break-up of the Soviet Union, and the 2006 post-'Orange Revolution' gas dispute was particularly bitter. But few predicted the longevity and intensity of this latest row. What initially appeared as the traditional annual bilateral clash between the two swiftly degenerated into a veritable pan-European gas crisis. The conflict lasted nearly 20 days and shut down gas supplies to 18 European countries for almost two weeks, leaving thousands of households to face a particularly cold winter and seriously disrupting European industry.

Had the European Union taken good note of the new circumstances under which this conflict was going to play out, it might have realised that this time around the gas clash would not be as easily dealt with as on previous occasions.

First and foremost, this year's crisis took place in the context of the global economic downturn. Russia's stock market has plummeted, losing roughly 70 per cent of its capitalisation since September. Capital flight has reached unprecedented proportions with a net balance of almost \$130 billion flowing out of the country in 2008. The Russian federal budget, which according to Finance Minister Kudrin goes into deficit at an oil price of \$70 a barrel, is coming to terms with an oil price fluctuating at \$40/bl. These new realities are beginning to spill into everyday life. Russia's unemployment rate is on the rise and the rouble has depreciated by roughly 33 per cent against the dollar since the summer – a gradual depreciation that has cost the Russian Central Bank some \$200 billion, or a third of its reserves. These developments are eating into the purchasing power and decimating the savings of ordinary Russians, raising the spectre of future discontent – a scenario the Kremlin would wish to avoid.

Gazprom's situation is no different. Weighed down with some \$50 billion in foreign debt its share price has sharply decreased. As a consequence, the state giant has dropped from being the 3<sup>rd</sup> largest company in the world to the 35<sup>th</sup>. Low oil prices and reduced bank lending are also aggravating planned investments in new production fields that are desperately needed due to years of underdevelopment. According to Yury Komarov, CEO of Gazprom's Shtokman Development, 70 per cent of the financing for the offshore Shtokman natural gas project will need to be bank-funded while the field will only be economically viable at oil prices of roughly \$60/bl.

These new financial difficulties have also effectively thrown a spanner into Gazprom's costly pipeline ventures. The construction of the Altai pipeline to China has already been halted and Prime Minister Putin has questioned the viability of the North Stream pipeline. This puts increasing pressure on Gazprom's strategic ambition to bypass Ukraine, which transits 80 per cent of the EU's gas imports from the post-

Soviet space, via pipelines such as North Stream and South Stream, the latter of which also faces legal uncertainties.

The economic rationale behind this conflict was therefore considerably stronger than before. Russia wanted to maximise its economic rent, securing a lucrative contract with Ukraine before gas prices start dropping, particularly in light of the fact that Russia agreed to pay higher prices for Central Asian gas. At the same time, if Russia can no longer afford to build a network bypassing Ukraine's pipeline system, it must seek to control it or at least curtail Ukraine's ability to interrupt gas supplies. For its part, Ukraine, one of the countries most severely hit by the economic downturn, wished to keep the price as low as possible. The first steps to accommodate both parties were already taken in October 2008 when Yulia Tymoshenko discussed a possible grand bargain with Putin. This envisaged lower-than-market gas prices in exchange for a 50 per cent stake for Gazprom in Ukraine's gas network – a deal similar in nature to that agreed between Russia and Belarus.

This gas clash, however, was as much about geopolitics and institutional infighting as about achieving a good rate of return.

The Byzantine nature of Ukrainian politics, with its ever-more damaging and frequent political crises, undoubtedly contributed to this stand-off. Common sense would suggest that the Russian-Georgian war would have led to increased solidarity within the Ukrainian political establishment. Not common sense, but political egos with Leninist *kto kovo* (zero-sum) thinking prevailed. The forces surrounding Yushchenko, Yanukovich and Tymoshenko are jockeying for position, in particular in the run-up to the presidential elections. Ukraine's opaque energy trade/system is no exception; in fact it is a frontline. Tymoshenko's supposed deal with Putin would have cut out RosUkrEnergo, a shadowy Swiss-based intermediary in the Russian-Ukrainian gas trade, half-owned by Gazprom and half-owned by several Ukrainian oligarchs such as Dmitri Firtash.

These people matter; even more in a system where business and politics are inextricably linked. They bankroll election campaigns and can, to some extent, make or break presidents. Firtash, in particular, is a major donor to Yanukovich's Party of the Regions and some have also drawn connections between him and Yushchenko going as far as alleging that he has Yushchenko's secretariat on his payroll.

For Tymoshenko, a former gas trader herself, cutting out such oligarchs from the lucrative energy trade can therefore pay political dividends. For Yushchenko and Yanukovich, keeping the financier and obstructing a grand bargain between Putin and Tymoshenko could be similarly beneficial. This domestic context should not have been underestimated.

Taking place in the aftermath of the war in Georgia, which demonstrated the precariousness of key EU diversification pipelines, this conflict also had a distinct geopolitical dimension. Russia is continuing its push to rout Western influence in what it considers its rightful zone of 'privileged interest', discrediting Ukraine as a liability, and emphasising to the European Union (as with Georgia) that true energy security lies with Russia alone via direct pipelines. While Russia's reputation as a supplier did also suffer, the Kremlin's public relations effort was much more co-ordinated this time around, which arguably softened the blow to its image.

More importantly, however, Moscow wishes to turn the delicate balance of power between both countries in its favour. Ukraine's ability to turn off the gas tap is one of the few important tools that can keep Russian policy in check. Russia therefore seeks to curtail Ukraine's gas leverage or control its transit system either by directly acquiring a stake or circumventing the Ukrainian corridor through its other planned pipelines. In this context, the EU's apprehension over Ukraine's transit system can play into Russian hands, strengthening EU support for Russia's alternative pipelines.

Another proposal in a similar vein currently circulating in Brussels is the establishment of an international gas transit consortium. Consisting of companies such as E.ON/RuhrGas, Gaz de France, ENI, Naftogaz and Gazprom, such a consortium would not directly own the Ukrainian gas pipeline, which is prohibited by the Ukrainian law 'On Pipelines', but would supposedly manage its gas transit system. The reasoning behind this proposal is that it would increase the EU's energy security by restricting Ukrainian gas leverage. It would simultaneously allow for the desperately-needed refurbishment of the Ukrainian Soviet-era pipeline system, which in its current state could also be considered a threat to EU energy security.

Although some of the ideas behind this proposal are not unworthy of consideration, it is essentially a political red herring. It not only smacks of neo-colonialism, but would also, as mentioned above, play into the Kremlin's hands, presenting the EU with a pyrrhic victory ultimately upsetting its position in Ukraine. Broader strategic goals, such as ensuring Ukraine's sovereignty, must not give way to short-term tactical solutions.

The same logic can also be applied to Russia's frail pipeline system. As it also is in dire need of refurbishment, why not launch an international consortium 'managing' Russia's Soviet-era pipelines??

Judging by the European Union's initial statement that this year's crisis was a 'bilateral matter', it is doubtful that it fully understood the complex interplay of the aforementioned factors. It thereby underestimated the conflict from the start. Even once it decided that the matter was no longer only a bilateral dispute it fared no better than in the Russian-Georgian war. Analogous to the first cease-fire settlement during the Georgia crisis, the monitoring agreement that was supposed to restart Russian supplies destined to Europe did little more than raise hopes of a swift end to conflict, which were quickly dashed.

By 19 January, Russia and Ukraine had themselves finally settled the matter. Under this arrangement Ukraine is to pay for its gas in accordance with a European pricing formula with an initial 20 per cent discount. In 2009 this should amount to roughly \$200-\$250 per thousand cubic metres (/mcm), while Ukrainian transit tariffs, now at \$1.70/mcm per 100 km, will rise gradually to European levels. Believing that this deal signals the end of tumultuous Russian-Ukrainian gas relations is wishful thinking. Moscow is determined to diminish Ukraine's transit leverage and Kiev will undoubtedly continue to rack up outstanding gas bills as the economic crisis savages the economy. Furthermore, the contract includes a *rebus sic stantibus* clause allowing for its revision, which President Yushchenko has already raised on multiple occasions.

In this context, the European Union must not fall back into its former complacency, which has allowed the annual gas conflict to worsen. Instead it needs to play an active part in tackling the deep-rooted structural problems in the Russian-Ukrainian gas relationship. This can be done via a range of policy measures. First, the EU must help reform and de-politicise the obscure and corrupt Ukrainian energy system by providing expertise and pressing for oversight and regulation.

Second, it must support Ukraine in addressing its appalling energy inefficiency. Ukraine has a vast untapped potential in this area. The Ukrainian Ministry of Construction estimates that nearly 60 per cent of energy is wasted within the district heating chain. An ambitious energy efficiency programme until 2020 could, according to a recent study commissioned by the Heinrich Böll Foundation, save Ukraine up to 329 million tonnes of oil equivalent (mtoe), with net savings equalling up to \$15 billion in 2020.

Third, it should seriously consider the proposal made by Black Sea expert John Lough to establish an EU-backed payment mechanism that allows Ukraine to incur debt in the EU rather than in Russia.

Fourth, it should encourage international financial institutions to look into the refurbishment of Ukraine's transit system.

Concerning the EU's domestic situation, the crisis yet again highlighted the need for a common European energy strategy – one that exists beyond the numerous communications and papers regularly published on this subject by Brussels. But Brussels alone cannot be blamed for the complacency and inaction of many of the EU's larger member states. These have, despite regular warnings, effectively inhibited the creation of a robust European energy market, opting instead for a national approach based on the premise that good bilateral relations with Russia will buy energy security. Nothing could have been further from the truth – as illustrated by Bulgaria's unfortunate difficulties during the recent crisis.

Contrary to common opinion, energy supply security cannot exclusively be found in Russia. Of course, Russia has an important role to play as a key energy supplier. But the EU's member states must begin to realise that energy security can also be found at home. In the long-term, renewable energy and energy efficiency are key pillars of a sustainable and secure energy system, while strategic gas storage and a robust trans-national intelligent energy network can provide the necessary short-term relief in case of disruptions and, more importantly, lay the foundations for energy solidarity.

The European Union has miscalculated the long-running Russian-Ukrainian gas row and has poorly understood the complex interplay of factors leading to this most recent dispute.

It is to be hoped that the EU has finally learned its lesson.

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