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Strain in the EU-Ukraine-Russia Energy Triangle

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Abstract

Ukraine's current tug-of-war with Russia over the pricing of its Russian gas imports should be watched closely by the EU, which receives 20% of its gas supply via Ukraine and which suffered record supply disruptions in 2009, the last time a similar price dispute escalated. After having accepted Ukraine into its Energy Community in 2011, the EU is rightly making further financial and diplomatic support conditional on Ukraine liberalising its domestic gas market. Those reforms, however, run counter the interests of well-connected local business magnates. Coupled, with EU concerns over the jailing of Ukrainian opposition leader Yuliya Timoshenko, Ukraine's resistance to reforms is cornering it into a difficult negotiating position with Russian Gazprom, which may well gain a stake in Ukraine's gas transportation system (GTS) in exchange for a discount. Alternatively, Timoshenko's release towards the end of 2012 may lead the EU to counterbalance Russia's growing leverage. In any case, however, vested interests are likely to continue hinder the liberalisation of Ukraine's domestic gas market, the only credible way to reduce energy security threats to the EU stemming from periodic Ukraine-Russia tussles.

Policy Implications

- Economic and political integration with the EU remain widely popular, long-term goals for Ukrainians. The local business elite also needs better access to European export markets. The EU needs to leverage its appeal to spur Ukraine towards making its gas sector more efficient and transparent. Such reforms would reduce energy security threats for the EU by reducing the likelihood of future Russia-Ukraine tussles.
- Ukraine's well-connected business interests will likely continue to resist the liberalisation of the domestic gas market, and any progress in that direction will be tentative and half-backed. If reform progress will be insufficient to allow for European involvement in upgrading Ukraine's GTS, the country will face even greater financial dependency on its Slavic big brother.
- Given uncertainty over Ukraine's ability to liberalise its gas sector based on European principles, the EU needs to prepare for Russia's expanding control over that sector, as well as over gas transit routes more generally. In this context, it is prudent for the EU to continue promoting alterative sources, such as LNG imports and, in the longer term, European shale gas.

For about two years Ukraine has been demanding a discount on the price of natural gas it imports from Russia. The last time a bilateral dispute over the topic escalated, in 2009, it led to the biggest ever disruption in gas supplies to the EU in the history of European gas trade. The stakes are still high for all three players: Ukraine is under pressure to cede control over its gas-distribution network, which it considers tantamount to surrendering sovereignty; Russia cannot afford a further blow to its reputation as supplier; while the EU receives 20% of its gas supply via Ukraine.

The EU's growing attention to Ukraine has not remained "on paper" in official documents and statements, but it has led to Ukraine being accepted into the Union's Energy Community from 1 February 2011. With its benign embrace the EU was hoping to extend its energy sector principles and regulatory standards to Ukraine. So far, however, Ukraine has failed to take convincing steps towards implementing its Energy Community pledges. In particular, Ukraine is supposed to unbundle gas sales from gas transportation operations by 2015, Ukraine will also have to set clear tariffs for any private operator to use the pipeline network to distribute the gas to domestic end users. Finally, Ukraine also needs to set-up an independent authority to monitor the application of those tariffs to various market participants. Generally, the EU is pressing Ukraine to make its energy sector more transparent and efficient.

Haggling

Instead of taking decisive steps in those directions, Ukraine has focused on demanding a gas price discount from Russia. This is understandable as the contract currently in force has pushed the price of Russian gas imports to $416 per thousand cubic metres (tcm) of gas in 2012, practically the same as the average 2012 price for the EU ($415), and higher than the FSU average ($320). And this includes a 30% price reduction secured in April 2010. The terms of the contract were so punitive for Ukraine that a Kiev court could (thinly) dress an overwhelmingly political sentence in the language of treason and abuse of office, when it jailed Former prime minister and current opposition leader Yuliya Timoshenko in October 2011 for having authorised the contract in 2009.

Russia has signalled that it may consider reducing the price only if Ukraine joins Russia-led regional integration projects, while Ukraine has responded by threatening (a little emptily) to unilaterally annul the 2009 contract on grounds of it being unfair and to seek international arbitration. The latest turn in late February has been the Russian offer of a 10% discount to Ukraine, which is unlikely to be substantial enough to secure an agreement. In December, the government had indicated that a price of $220-250 per tcm would be fair.

The EU has refused to get drawn into Ukraine's gas price negotiations with Russia or to commit to help finance the upgrading of Ukraine's GTS before the country starts implementing its Energy Community pledges. In the meantime, EU energy companies have sent a clear warning to Ukraine in the last few years by joining Russia-led pipeline projects – the Nord Stream and South Stream pipelines (on which more is below) - that deliver Russian gas to Europe bypassing Ukraine's territory.

From bad to worse negotiating position

Ukraine has long been unable to afford Russian gas prices. In the 1990s, Ukraine's fledgling and energy inefficient economy was often unable to generate the state finances required to pay for Russian gas imports. From 2005, Russia's new policy of gradually bringing gas prices for the "near abroad" to European levels, as well as rising prices of Russia-delivered Turkmen gas from 2009, which forms 50% of Ukraine gas imports, severely compounded the affordability problem. At the same time, Ukraine has lacked the political will to increase domestic gas prices at the required speed. So, national oil and gas company Naftogaz has had to import Russian gas at growing prices while selling domestically produced gas to domestic customers at regulated prices.

The so-called 'gas wars' in 2006 and 2009 (during which gas supplies were suspended) and a chill in relations with the EU have further weakened Ukraine's leverage – as has the obstructive agenda of influential domestic oligarchic interests. The gas wars also represented a crunch point for Russia, because it is contractually responsible for supply interruptions to European customers, regardless of the (mis)behaviour of transit countries. Moreover, the seriousness of the wintertime supply suspensions prompted a major European political backlash against Russia.

Diversification of transit and imports

The gas wars also expedited Russia's plans to build two pipeline systems to Europe that would bypass Ukraine and other non-EU countries. The first of two strings of one of these systems – the Nord Stream project, which transports gas directly from Russia to Germany under the Baltic Sea – became operational in 2011; the second will follow this year. The other bypass project, South Stream, is designed to deliver Russian gas to South-Eastern Europe via the Black Sea, with Serbia – one of Russia's strongest allies in the region – as the only non-EU transit country.

Construction of South Stream is expected to begin by the end of 2012, facilitated by Turkey's decision in December to allow the pipelines to pass through its exclusive economic zone under the Black Sea (instead of Ukraine's). It is not expected to start operating until late 2015 at the earliest. The two bypass pipeline systems will have a combined capacity of 85 billion cubic metres (bcm) per year by 2015-19. This would not be "new gas" but gas re-routed from pipelines transiting Ukraine, which would be left with only around 30 bcm-50 bcm of transit gas. Notably, a number of the largest European energy companies (German E.ON and BASF/Wintershall; Dutch Gasunie and French GDF Suez for Nord Stream; and Italian ENI, French EDF and German BASF Wintershall for South Stream) are participating in both projects, which is reducing their interest in managing and upgrading Ukraine's 13,670-mile (22,000 km) network, the largest in the FSU outside Russia.

In an attempt to exert pressure on Russia, Ukraine's government keeps threatening to drastically cut its Russian gas imports, to diversify its import sources and to boost the role of non-gas energy carriers in the country's energy mix. Unfortunately, these aims will remain little more than wishful thinking for at least another four years, because Ukraine does not have a liquefied natural gas (LNG) terminal and has so far failed to secure much trumpeted gas from Azerbaijan. Its main industries (steel and chemicals) are very energy hungry and inefficient. Russian gas accounts directly for almost 40% of Ukraine's consumption, and Gazprom is contractually responsible for delivering another 40% from Central Asia.

Vested (dis)interests

Ukraine's private oligarchs, whose main interests in the metals and chemical industries depend strongly on gas, have arguably prevailed over EU pressure to liberalise the energy sector and make it more transparent. EU's demands for reforms are understandable given that Ukraine's opaque and state-regulated energy sector has been the fundamental cause of its disputes with Russia. More precisely, successive governments have been reluctant to introduce aggressive (and socially painful) hikes in domestic gas prices, and this is now particularly relevant in the run-up to parliamentary elections in October. Moreover, local business magnates are widely believed to secretly divert a share of domestically produced gas, which is by law reserved for households and whose sales price is heavily regulated by the state.

Such price regulation weighs heavily on national oil and gas company Naftogaz's budget, making it very difficult for Naftogaz to pay for increasingly expensive Russian gas imports. If the industries of Ukraine's most powerful and best-connected business magnates covertly benefit from capped domestic gas prices, it is reasonable to expect that those magnates are lobbying the government to keep the regulated prices and resist any reform of the energy sector that may throw light on their illicit schemes of gas diversion of pass through to them the cost of gas imports more directly.

The same oligarchs have also consistently lobbied the government to secure cheap supplies of Russian gas. However, one thing local magnates fear more than costly Russian gas is the prospect of Gazprom distributing it directly through the acquisition of a stake in Ukraine gas distribution network, which would give Russia even more leverage over much of Ukraine's industry. This is probably why the government late last year suddenly started stating that Ukraine could afford the current gas price charged by Russia after all, while simultaneously claiming it is unfairly high. Indeed, if the only way to get a discount was for Gazprom to gain an important stake in Ukraine's domestic gas distribution, then high prices would be the lesser of two evils for the government and its business allies.

By having resisted Russia's involvement in the management (and upgrading) of the domestic gas-transit network, the oligarchs' agenda has probably caused Ukraine to miss out on beneficial Russian input over the last few years. As its bypass pipeline projects gradually become operational, Russia's ambition has diminished from wanting to manage Ukraine's pipeline system to seeking co-ownership, and at highly favourable terms. Ukraine's oligarchs may soon have to concede at least some stake in Ukraine's GTS to Gazprom.

Ukraine's appeal

Gazprom is facing an increasingly challenging market in Europe, where LNG provided over 20% of imports in 2011, shale gas may provide significant new supplies in under a decade, and the EU's gas trade liberalisation and competition agenda is obstructing Gazprom's plans to acquire downstream assets in the region (and requiring it to unbundle supply and delivery where it already has such assets). In this context, Ukraine is an appealing, relatively-large and very energy-inefficient market. It will likely to remain more dependent on Russian gas and offer greater downstream opportunities for Russia than EU countries. Indeed, downstream expansion would allow Russia to sell gas directly to Ukraine's industrial consumers, who (on paper at least) are paying $560 per tcm – well above gas import prices. Moreover, Ukraine's 34 bcm gas-storage capacity, the second largest in Europe after Russia, is also appealing. Finally, Russia cannot afford further gas wars to tarnish its reputation in Europe, and is unlikely to immediately push for a controlling stake over Ukraine's GTS, as this would smack of monopoly over gas transit too strongly too soon.

Endgame

Given that both parties have strong reasons to reach a compromise, and that integration with the EU energy space seems to run counter Ukraine's oligarchic interests, Russia-Ukraine negotiations on a gas price discount are likely to ultimately lead to an agreement. This is more likely to happen now that the Russian election cycle is over and President-elect Putin can devote more attention to the issue. But negotiations will be tough and time is of the essence. Ukraine needs a deal before Russia starts building South Stream. To convince Russia to commit to its transit route, Ukraine is likely to have to accept some form of minority involvement of Gazprom in the ownership structure of an unbundled Naftogaz, as the company's extraction and distribution functions are supposed to be separated according to government plans. This unbundling will probably take years to complete, postponing the effect of a new Gazprom stake, and giving local oligarchs a bit of time to adjust.

If no deal is reached, Russia would still be likely to extend more loans to Ukraine to pay its gas debts. This would make Ukraine even more financially dependent on Russia, which would ultimately merely postpone the day of reckoning. Gazprom gaining a foothold in Ukraine's gas-distribution business in the next 3-5 years would strengthen the prospects of other Russian companies extending their presence in Ukraine's economy, undermining fair competition for other foreign investors. Within the sector, the prospect of Gazprom's growing leverage over Ukraine's gas-transport system would probably lead to it expanding its role in gas-field exploration in the Black Sea shelf already in the short term, with the strength to potentially jostle out rivals.

EU energy security

The EU has remained largely on the sidelines with regard to this situation. It considers on-going price negotiations as a bilateral matter and it is determined not to commit to forming a consortium with Russia to manage Ukraine's gas-transport network until after Ukraine starts seriously reforming it energy sector. Meanwhile many European energy companies are becoming too deeply involved with Russia's Nord and South Stream projects to consider investing billions in upgrading and running the Ukrainian route, an investment hard enough to sell even without the bypass projects. The announcement in March that German AEG has tentatively agreed to invest 400mn euro in upgrading Ukraine's gas pumping stations does not seem sufficient to change the overall picture, given that modernisaing the aging GTS is estimated to cost $5-7bn over the next 5-7 years.

All in all, the bypass pipelines are probably more conducive to energy security for the EU. After all, once the pipeline is built, the sunk investment provides an incentive to fill it with gas, although these pipelines are very expensive to build and operate. The political and diplomatic context of Russia-Ukraine trade relations overall is much more benign than it was at the time of gas wars, which will help to mitigate the risk of any repeat of those supply disruptions.

In the longer run, Ukraine's difficulty in paying for Russian gas supplies, in turn largely due to state regulated domestic prices, poses the main threat to supply security. This is to a large extent a question of Naftogaz's financial viability and one that depends heavily on making Ukraine's own gas sector more transparent and liberalised. Incidentally, regulated domestic prices also constrain Gazprom's upstream investment in Russia. Ukraine has committed to introducing an *aquis*-consistent gas law, which the government appeared to have done in July 2010. However, this law does not appear to be stringent enough.

As of late March 2012, Ukraine appears stuck: frosty relations with the EU and well-connected magnates continue to hinder gas sector liberalisation and to corner Ukraine into a difficult negotiating position with Gazprom. If Timoshenko were to be released from jail, most probably after the October elections, based on a claim currently being considered by the European Court of Human Rights, the EU would probably provide some counterbalance to Russia in this energy triangle. For example, this could rekindle hopes of EU participation in the upgrading and managing of Ukraine's GTS, though Ukraine would be unlikely to offer more than palliative gas sector reforms in exchange. In any case, time is running out, with Russia set to start building South Stream by the end of this year, thus devaluing Ukraine's GTS.

Either scenario - renewed EU interest or Gazprom's growing leverage – would be unlikely to foster a genuine push by Ukraine towards the liberalisation of its domestic market under EU *aquis* principles. By hindering reform, local vested interests may condemn Ukraine to losing yet another decade, muddling along, continuing to court both of its two neighbours without committing to either. This would hardly make the EU-Ukraine-Russia triangle a bastion of EU energy security.