# LIGHT AT THE END OF THE TUNNEL? THE GAS CONFLICT BETWEEN UKRAINE AND RUSSIA

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Ukraine has always been important to the Soviet Union as well as to present-day Russia as a provider of gas and technology. Gas extraction in the west Ukrainian province of Galicia began early in the 20th century. In 1948, a pipeline, the biggest of its time, was built from Dashava to Kiev and later on to Moscow. After the war, the country not only provided the important infrastructure for the gas sector, it also was home to most of the sector's research and teaching institutes. In the fifties, large deposits of gas were discovered in central and eastern Ukraine, and the focus of extraction shifted towards the east. For Soviet planners, natural gas was important with regard to the chemical and arms industries. Extraction reached its peak in the seventies. Afterwards, volumes declined, rising again after 2004 to level off at c. 20bn m3. In the eighties, the demand for gas grew in the heavy and arms industries, putting Ukraine under pressure because of the economic dependence on gas supplies from Siberia and Turkmenistan. After the collapse of the Soviet Union, this economic dependence became political as well.

In the post-Soviet era, intransparency was the hallmark of the gas supply system, all the more so as the prices for gas imports as well as for the transit to Europe were fixed in bilateral treaties and kept at a low level. Recurrent gas crises characterized the nineties. At the time, Russia was delivering about 80 to 90bn m3 per year to the national Ukrgazprom AG which, however, paid only rarely. The debt thus racked up until 1994 amounted to 4.5bn US dollars. In both 1992 and 1993, Moscow threatened to curtail and/or stop its deliveries. It was only after President Kuchma came into office in the Ukraine that part of the debt was settled. Yet the industry remained as intransparent as before, especially because intermediaries now appeared on the scene. The first concessions were granted in 1996, when the country was engaged in trading in gas from Turkmenistan. As long as the political sphere concurred, the system worked, including dubious swaps by way of payment. Both Russians and Ukrainians were able to cut back their taxes to a minimum because a letter box company supported by both sides acquired gas for resale at 'mar ket prices' to European customers who were anything but dissatisfied.

In 1998, Naftogaz AG was founded but the project failed, although various positive reforms were implemented: the electricity market was liberalized, and swaps were banned. At the same time, the gas sector remained as intransparent as before. Early in 2006, a conflict arose when Russia suspended deliveries to Ukraine for several days. The 'world market prices' which Moscow now demanded would have forced Ukraine to increase its payments five-fold. Although an agreement was reached, it was rather unsatisfactory to Kiev.

Deliveries to Ukraine were again suspended on January 1, 2009, and to Europe one week later. However, Ukraine was ready this time because it had switched its own pipeline system to autonomous operation before. After the dispute of 2006, gas was supplied to Ukraine by an odious intermediary, RosUkrEnergo. The asking price was 179.5 US dollars per 1,000m3, still below the European level. As the Ukrainian Naftogaz AG had been having payment problems for quite some time, Gazprom finally demanded that all back debts, which were said to amount to 2.1bn US dollars, be settled immediately. While Kiev did pay 1.6bn US dollars, it rejected Moscow's demand for the payment of 600 million US dollars in interest on arrears. When Moscow went on to quote a 'friendship special' rate of 250 US dollars per 1,000m3, negotiations were broken off. Russia may well have wanted the dispute to escalate. Experts believe that Moscow had an eye on political as well as economic aspects, aiming not only to sell gas at world market prices but also to gain control of the pipelines. Another intention had been to weaken Ukraine internally and 'punish' it for its pro-western course.

Both sides endeavoured to internationalize their infighting early on. While Russia launched an effective media campaign that was clearly propagandist, Ukraine observed a more balanced attitude. Still, neither side is without blame. On the one hand, Kiev maintained for a long time that it had no debts at all. On the other, Ukraine would have had to pay through the nose if it had recognized Russia's 'special friendship' rate as it did not include the charges for what is called technical gas, which also would have had to be bought from Russia to facilitate the transit of gas destined for Europe. The transit business would have ruined Naftogaz in the long run, although Ukraine's position remained open to criticism, and Gazprom was firmly convinced that it would gain the upper hand in the end.

When Europe's supply of gas dried up on January 7, the EU's endeavours remained altogether fruitless at first. On the 12th, an apparent compromise brokered by Czechia was hammered out. Yielding to Moscow's demands, Kiev granted international experts access to the gas storage facilities on Ukrainian territory. At the same time, the agreement did not provide for access to storage facilities on Russian territory. Nevertheless, the Ukrainian prime minister, Mrs Timoshenko, promised that transit deliveries to Europe would be resumed as soon as Russia would resume its own. Kiev wished these deliveries to be made on the old terms for the time being, i.e. at a temporary rate of 1.7 US dollars. The mediator, Czechia's Prime Minister Topolanek, was satisfied.

When, however, no gas was flowing through Ukraine on January 13, both sides blamed each other. While experts pointed at problems encountered in the search for an adequate gas route, the Ukrainian side alleged that Russia was incapable of stepping up its production far enough to supply the requisite volume.

It was only on January 18/19 that a compromise was reached between Vladimir Putin and Julia Timoshenko. In effect, gas will be supplied to Ukraine in 2009 at a 20-percent discount on the baseline market price, which was fixed at 450 US dollars per 1,000m3. Gazprom will supply directly to Naftogaz without any intermediaries, but access to the Ukrainian market will remain in the hands of a Gazprom subsidiary, Gazprobsbyt Ukraine. Transit charges to Europe will remain moderate for the time being, but import as well as transit prices will be brought up to market level from 2010 onwards.

Neither Ukraine nor Europe were prepared for the total suspension of deliveries in January of this year, especially as no one had expected Russia to be willing to stop contractually agreed deliveries to Europe and run the risk of suffering political harm itself. And indeed, the images of both Russia and Ukraine now appear considerably tainted, as gas supplies from Russia can hardly be considered predictable at present. While circuitous pipelines might secure the supply of individual countries, there would be no security of supply for Europe as a whole.

Europe will probably have to say goodbye to its role of passive observer and follow a more active energy policy to meet its own needs without disregarding Ukraine’s interests. It is unfortunate that Ukraine should currently be regarded as an unpredictable country which, having destroyed the confidence formerly placed in it, urgently needs to define a sound policy of its own, supported by clear information. At all events, Kiev neither won nor lost the media war with Russia, having failed to launch it in the first place. Reasons include the total lack of a national political course, the confusion that reigns in the coordination of government authorities, and the government’s inability to explain this complex matter to the general public.

Delaying the transition to a European pricing formula was certainly a false move on the part of Kiev. Its low-price policy laid the country open to blackmail for a long time, impairing the competitiveness of its heavy industry on the international stage and preventing it from seeing the need for modernizing its energy infrastructure. Only the recent treaties, in which gas import and transit prices are fixed on the basis of a formula instead of bilateral agreements, have opened a door to greater transparency. The elimination of intermediaries is another positive aspect which, however, is not to Mrs Timoshenko’s credit, for after all, the operation of these dealers did run with the interests of both sides for a time.

The plans of the Ukrainian prime minister might bear fruit if the price of gas should not rise for some time. Even so, Naftogaz might stumble into a debt trap once again. Higher gas prices might throw the heavy industry of the country, already hard hit by the economic crisis, into a recession. Yet another potential hazard is the devaluation of the national currency.

The leaders in Kiev will have to abandon their policy of subsidising gas prices sometime soon, all the more so as the gas treaty is tricky in several respects. Gas transit charges remain as unsettled as the question of what is to become of the debts of RosUkrEnergo. The latter aspect especially might stir up political turbulences in the country itself. One thing is for certain: if the energy sector should not be reformed comprehensively, crises even more explosive than the one that has just been overcome will be inevitable in the future.

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