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## **Upping the Stakes**

*Some lessons for the EU from the recent Russia-Ukraine gas crisis*

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## **Upping the Stakes; Some lessons for the EU from the recent Russia-Ukraine gas crisis**

The stakes in the gas conflict between Russia and the Ukraine were upped up to an unprecedented level. The reputation of both countries, one as a reliable supplier to EU markets and the other as a reliable transit country have been dramatically shocked. The disruption of supply and the impact on gas markets in Eastern Europe will require a new round of thinking on how best to improve on security of gas supply. These responses *should not* include a turning away from the Ukraine as a transit country or from Russia as an important supplier, but rather the opposite, a renewed engagement of these two countries to help them construct a stable and healthy relationship in which (also) gas flows can be secured throughout the value chain. EU security of supply is the mirror image of security of transit and security of demand, and it is clear that all three securities should be addressed and integrated into one security for all. Integrating the securities along the gas value chain will allow us to move away from increasingly politicising the conflict and instead deal with the diverging interests at a more economic level. The politicising of the conflict is increasingly holding all the stakeholders hostage, preventing progress in integrating our markets and preventing large investments along the value chain to take place that are important for Russian security of supply, Ukrainian security of supply and EU security of supply. Perhaps that the recent escalation of the conflict can serve as a sombre warning signal that all parties mismanaged the vital gas relations with the short disruption in 2006 and the longer disruption in 2009 as a sorry result.

### **Crossing the line**

The conflict over gas between Russia and the Ukraine is becoming somewhat of a new year tradition. With the onset of winter the negotiations on price and transit fees between the various gas companies of both countries and their governments commence; some year they come to an agreement in the nick of time and twice they did not, leading to a short disruption of the gas flow to the European Union in 2006 and a more prolonged one in 2009.

The political and reputational impact of the 2006 conflict and the fact that the prime ministers of both countries met early on and signed a memorandum of understanding, led many of us to the conclusion that this time round the countries' leaders and their companies would settle their business before the expiry of the contract. Yes of course they would leave the fine details to the last minute before settling their differences, but they would shy away from a repetition of 2006. Russia would not want to jeopardize its reputation as a reliable supplier, certainly not in the midst of an economic crisis, while the Ukraine, or certain factions in the country, would not want to antagonise the countries that were crucial to its rapprochement of either NATO and/or the EU. Or so we thought. We completely misjudged the level of frustration and, perhaps because of the economic crisis in both countries, the 'va bank' attitude to influence the obscure governance of the gas transit to their own interests. An additional complication was the inter-elite fight over gas rents in the Ukraine, making it, among other things, very unclear which political representative had ultimately the clout to negotiate an agreement.<sup>1</sup>

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<sup>1</sup> Edward Chow and Jonathan Elkind, Where East Meets West: European Gas and Ukrainian Reality, *The Washington Quarterly*, January 2009, pp. 77-92.

In many ways the conflict increasingly was bearing the hallmark of incomplete disintegration of the old structures and insufficient integration along new political, economic and institutional principles.

The EU should feel somewhat responsible for the level of frustration in both the Ukraine and Russia because it is not just an innocent bystander, a victim of eastern irrationality, but in many ways an active participant in shaping the context of the complex (energy) relations on the European continent. The enlargement of the EU with some of the former Comecon countries and the Baltic States has left a political, economic and institutional divide across the European continent, which it has been unable to overcome with partnership or free trade agreements, to create an inclusive rather than an exclusive Europe. Also here incomplete disintegration of the old structure and insufficient integration along new structures are at fault. This implies that ownership of this conflict does not only fall to the Ukraine and Russia, but also to the EU, and all should therefore assume responsibility for resolving it to create a workable (energy) economy for all.

### **Complex relations**

When supplies were interrupted a few days into the conflict between Russia and the Ukraine, doubts were immediately raised about EU gas supply reliability, including from the IEA<sup>2</sup>. The EU is currently importing Russian gas through pipelines of about 120 bcm a year, covering about 25% of its total gas consumption of 480 bcm. The EU imports represent about 80 % of total Russian gas exports, and of these exports about 80% is moving through the Ukraine. The Ukraine is a lynch pin in Russian gas reaching the EU market. In addition, the Ukrainian market is with an annual consumption of about 65 bcm one of the largest European gas markets. Due to falling domestic production (19 bcm in 2007) the Ukraine is increasingly dependent on imports from or via Russia<sup>3</sup>. The pricing of the gas for the Ukrainian market and the transit conditions for the gas destined to the EU market has been a continued source of conflict between the two countries since the early 1990's. As long as oil prices were relatively low, the problem remained concealed for the EU, but did impact the bilateral relations between Russia and the Ukraine. When oil prices began to increase in the late 1990s, and gas prices followed suit, the impact of these price increases began to pain the Ukrainian economy to the extent that normalisation of the gas trade, including more market related gas contacts which had been negotiated with other former Comecon and Soviet Union countries, could not easily be extended to the Ukraine. Together with Belarus they remained the least restructured (energy) economies. The reorganisation of the Russian energy sector after 2000 and the subsequent more assertive energy diplomacy, also in response to changing energy markets in the EU, strained the Ukrainian-Russian energy relations further. The vested interests of the Ukrainian industry in low priced Russian and Caspian energy and the growing EU orientation of other elites have been clashing since. The Orange revolution, despite its hopeful start, has not been able to create a clear direction for the Ukrainian economy, but made the strain on bilateral political and economic relations larger. This stress also affected the gas relations when Russia tried to reconnect its resources to its export markets by

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<sup>2</sup> Statement by Fatih Birol, the IEA's chief economist in ....., calling this crisis another wake-up call for the EU to restructure its energy supplies, adding that "Russia has cut off its status as being a reliable suppliers for Europe". An official IEA statement from 16.01.2009 however is more nuanced in stating: "The way both parties have acted over the last weeks and notably this week is unacceptable. This casts a shadow over the reputation of Russia as a reliable supplying country for Europe. It leaves consuming countries no other option than to speed up moves to find alternative suppliers, fuels and transit routes in the future".

<sup>3</sup> Figures are coming from the BP Statistical review of World Energy 2008 (<http://www.bp.com/subsection.do?categoryId=9023762&contentId=7044550>).

attempting to barter lower gas prices for an ownership share in the trunk lines as it had done in Belarus. Although understandable from Russia's perspective to try to assume some control over these vital export pipelines, due to the physical construction of the pipeline infrastructure, it would also give Russia's gas company Gazprom a say about Ukrainian gas flows. For the Ukraine that was not acceptable, and also the EU was anxious to prevent such control over gas flows from one of the main external suppliers to its market. The EU has been pushing to export its regulatory model eastward to defuse the monopoly power over gas transit and export, i.e. Naftogaz and Gazprom. But both parties had deep-rooted interests in letting their power not be defused. Increasingly it became clear that the political dimensions to this conflict between two post-Soviet states was intensifying. The year 2008 were typified by Russia's attempts to resist the containment policies in its Near Abroad by the West, while Ukraine became more deeply split internally over its western or eastern orientation. Nearly twenty years after the break up of the former Soviet Union, the separation pains became increasingly confrontational.

In the weekend of January 17/18 the prime ministers of both countries had finally come to an agreement about prices and transit fees, although at that time it was not entirely clear whether the agreement would be supported by the president of the Ukraine. His tacit support came a week later. Part of the agreement was also that the middlemen, intermediary companies, would be removed from the gas trade. An issue that had particularly created political strife in the Ukraine.

### **Limbo**

With the crisis behind us, it is time to ask some pertinent questions. Was the drama that we were forced to witness between the leaderships of both countries and the cold endured in some EU countries caused by a commercial dispute gone political? Or was it a political dispute with a commercial core? Without going into the more fickle points of these questions, and before turning to the questions what the EU can do to improve its gas security, we make note of two observations:

- In their 16.01.2009 FT commentary, campaigners from the anti-corruption watchdog Global Witness are writing among other things "... (quoting Putin) What the Ukrainians are fighting for is not the price of gas, but a chance to keep this or that middlemen in order to use the dividends for personal ends and enrichment", adding that also Ukrainian's PM Julia Tymoshenko made similar comments about "senior political officials" in her country.
- In their very interesting article in the Washington Quarterly<sup>4</sup> Edward Chow and Jonathan Elkind are concluding that "Ukraine (being) a country generously endowed with many assets....The current form of (its) energy sector, however, needs to be seen for what it is, a major threat to itself and to its neighbours. If Ukraine fails to modernize its energy sector practices, ....it will threaten Europe's own energy security. Ukraine has the potential to change this story line, ...but only after the political will for energy reform is in place. (It) would not only help Ukraine but...would arguably be Ukraine's single most important contribution to improve the security of the trans-Atlantic community. ....Continuing failure (however) .....would be a clear signal that Ukraine is not ready to pursue its stated desire of becoming a more integral part of the Euro-Atlantic community.

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<sup>4</sup> "Where East meets West: European gas and Ukrainian reality"; Centre for Strategic and International Issues, The Washington Quarterly, January 2009, pages 77-92

It is obvious that the Ukraine can never become a serious partner in the European family of countries when it fails to deal with the kleptonomics of its ruling elites. The failure of the elites to help create a functional state for its own citizens and for the neighbouring countries have undermined the economy, the political viability and the security in central Europe. Nearly 20 years into independence has benefitted few over many, has left the economy barely restructured on a new footing, while the Orange revolution has so far failed to change the path of the country and to redefine the national interests away from special interests. Yet it is clear that legacy and the context of developments on the European continent played a role too in shaping the Ukrainian reality of today. The Russian renaissance, after a period of political and economic turmoil and helped by increasing world energy prices, has also contributed to the conflict. The Ukraine increasingly was left in limbo, stuck between the new EU and the newly emerging Russia.

### **EU external energy security**

The impact of the conflict on the EU gas market was substantial. Countries suffered shortages and in Bulgaria and on the Balkan basic energy needs could not be met. The situation was aggravated by the fact that some important gas infrastructure demands arranged for in the 2004 and 2007 accession treaties had been not (yet) been addressed. To improve the external gas security several things can be done, although they will not result in an immediate improvement in supply security. It is obvious that a new approach and engagement with the Ukraine is needed. Developing alternative supply routes is another route to enhance security, and finally, enhancing and deepening the dialogue with Moscow on energy matters should not be delayed.

On the EU-policy vis-à-vis the Ukraine, a re-evaluation seems to be appropriate. It could be helpful to use the forthcoming negotiation of Ukraine's accession to the Energy Community Treaty to address a number of specific internal energy policy issues. The earlier mentioned Chow/Elkind article provides a roadmap for that. They are suggesting a five-step approach for energy sector stability in the Ukraine:

- To start serious negotiations with Russia on a long term agreement on gas supply and transits, based on a professional approach to the matter. It could be useful if these negotiations would be facilitated by an independent moderator<sup>5</sup>.
- To transform state-owned Naftogaz into a functioning commercial company so that it no longer the "black hole" that it is today.
- The removal of all middlemen, including RosUkrEnergo, as they impose not only a risk to European gas supply chains due to their intransparent operations, but also a hidden cost to Ukrainian consumers, Russian taxpayers and Gazprom shareholders.
- To establish a serious energy efficiency programme in the Ukraine, both by reforming domestic gas prices and diminishing gas consumption. It is frustrating to see that Ukraine's energy intensity is not only higher than the one in western Europe, but even twice as high as in neighbouring Poland.
- To improve the investment climate for exploration and production of hydrocarbons. Ukraine has interesting potentials to enhance its production of oil and gas, reducing the country's growing energy import dependence.

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<sup>5</sup> This could be done for instance by George Verberg, former ceo of Dutch Gasunie, that has also been suggested to direct an eventual arbitration by the Energy Charter Secretariat ([http://www.encharter.org/index.php?id=21&id\\_article=167&L=0](http://www.encharter.org/index.php?id=21&id_article=167&L=0))

With regard to developing alternative supply routes it is clear that diversification of transit routes will reduce the power to hold up suppliers and off takers. The diversification of routes alone is not enough though, and the EU should do its utmost to also diversify its supplies, both by attracting new pipeline supplies and by LNG. The reality is that in all supply scenarios, also in the most conservative of scenarios presented in the Strategic Energy Review, Russia will remain an important supplier to the EU. In most scenarios, however, more Russian gas is needed to supply the European market, in addition to supplies from other sources. The uncertainty surrounding the availability of Caspian gas, other than through the Russian route, and the uncertainty about the timing of Iraqi and Iranian gas underline the importance of securing sufficient Russian supplies. Moreover, diversifying routes for Russian gas is an important security of supply measure, not in the least because it underpins investments in new gas provinces important for future security of supply. And if Russia is deemed a difficult gas trading partner, the country with the second largest world gas reserves, Iran as a possible new supplier, is also not the easiest to trade with. Moreover, the time required to develop alternative gas supplies in sufficient volumes to replace some of the Russian flows is daunting from the perspective of reaching a gas security comfort level. Alternative suppliers for the EU, such as the Caspian basin, Norway, Algeria, Nigeria and some smaller other suppliers are already all playing their role.

More gas could come to the EU market, however, but each supply route has its own specific positive and negative conditions and requirements, including transiting other countries as well. The growing role of LNG-imports is one option to further pursue, but other countries are also increasing their LNG intake and the LNG market is expected to be tightening again after the current financial and economic crisis. Minimising transit risks, such as will be the case via the planned Nordstream pipeline is a further route to be developed and enhanced, bringing Russian gas on a continuous basis deep into EU-markets without the risk of difficult transit issues. The availability of this route can also be an important stimulus for the Yamal investment developments, important for future Russian and European energy security. The same would apply for the Southstream project with its direct connection from Russia to more south-eastern EU-markets. Also the Nabucco-project is an interesting road to build upon, especially when additional financial arrangements could be put in place to give further incentives for non-Russian suppliers (eventually including Iran). Given its incremental approach, this project can grow over time with the increasing demand for imported gas and the potential availability of Iraqi and Iranian gas. What is clear is that the Ukrainian corridor must lose its near monopoly both for Russian security of demand and European security of supply reasons. The conflict has proven the merits of the alternative routes for Russian and other gas flows. In the future the Ukrainian corridor, however, will remain an important, but not exclusive gateway for gas into Europe. Particularly when the Ukrainian oil and gas investments would result in more locally available gas, the Ukraine can develop into an important hub where flexibility services can be provided on various gas sources. But for that to materialise the political and economic stability in the country is crucial, and a good maintenance track record, contractual certainty and transparency must be established. For the moment, the recent crisis and the ongoing financial difficulties of Naftogaz are a strong argument for a sped up development of alternative routes.

On EU-Russia relations we are referring to the conclusions in a recent Clingendael publication on EU-Russia<sup>6</sup>. Energy is and will remain a key element in EU-Russia relations. Resource rich Russia has,

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<sup>6</sup> See “The European Union and Russia: Perception and Interest in the Shaping of Relations”, André Gerrits (ed.), Max Bader, Marcel de Haas en Jacques de Jong <http://www.clingendael.nl/ciep/publications/?id=7299&&type=summary>

despite the recent events, a strong record of a stable and reliable energy partner of the EU. With the world's largest known natural gas reserves, Russia will continue to be of great importance for meeting the EU's future gas needs. Building on the principles agreed in the 2006 G8 Petersburg statement on energy, new avenues for discussing energy market designs, regulation and access should be explored in order to strengthen energy relations in a mutually beneficial way. Recent statements from president Medvedev, calling for a "new international mechanism" to govern Russia's gas trade with Europe should be approached in the spirit of the Petersburg statement, especially where it stated that competition should be encouraged on the basis of the rule of law in energy trade. Medvedev's statement that Moscow would never ratify the European energy charter, which aims to encourage competition and enforce the rule of law in energy trade, should be interpreted in the said Petersburg spirit. Moreover, also developments in the Russian market should not be underestimated. More and more Russian gas will come from Independent producers and they are also interested in sharing in some of Gazprom's export revenues. Russian prices are also increasing and with the European prices bound to decline later this year as a result of lower oil prices, the gap between Russian and European prices is to narrow and perhaps catch up depending on the depth of the economic crisis.<sup>7</sup>

### **Internal EU Policy Measures**

The EU can also improve its own internal security. Investments in storages and pipeline interconnection between the various parts of the EU internal gas market should be stimulated forthwith. The EU *should not* respond by just imposing national strategic gas storage quota, but rather aim at a smarter security of supply policy that transcends the fuel by fuel approach. The energy mixes of the EU member states is very diverse, but as a result also offers more diverse solutions. It is cheaper to store oil than gas, and some member states underground are not suitable for gas storage. Member states should be invited to show how they improve on energy security by using the wide palet of possibilities, such as disruptable users, dual-firing capacity, etc. In this presentation, new interconnection in gas and gas storage can also play its role. Energy security is best seen integrated.<sup>8</sup> With the confidence that all member states are developing integral approaches to energy security, and not free-riding on the measures of other member states, energy solidarity will be easier to create, also in the event of a gas supply disruption. Because first and foremost, the EU should adopt a crisis mechanism so that confidence in the EU internal energy market and the hardness of the underlying

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<sup>7</sup> Russia increased gas prices with about 19% in January 2009. If Russia can maintain its price increase schedule is unclear given the depth of the economic crisis in Russia, the government could be tempted to reduce the burden on its battered industry and decide to temporarily stabilise prices.

<sup>8</sup> Study EU Energy Supply Security and Geopolitics (Tren/C1-06-2002), Study conducted by Clingendael International Energy programme (CIEP), Institute for International Relations 'Clingendael', The Hague, The Netherlands for DGTREN

<http://www.clingendael.nl/ciep/publications/studies/?id=5706&&type=summary>;

Perspectives on security of supply in European natural gas markets, Christoph Tonjes and Jacques de Jong, The Hague, Clingendael Institute, August 2007,

25 pp. <http://www.clingendael.nl/ciep/publications/misc/?id=6756&&type=summary>;

*EU Standards for Energy Security of Supply (update)*, Jacques de Jong, Hans Maters, Martin Scheepers en Ad Seebregts (EN) CIEP, The Hague, Clingendael Institute/ Petten, Energy Research Centre of the Netherlands, CIEP/ECN, April 2007; [http://www.clingendael.nl/publications/2007/20070400\\_ciep\\_misc\\_dejong-maters-et-al\\_update.pdf](http://www.clingendael.nl/publications/2007/20070400_ciep_misc_dejong-maters-et-al_update.pdf);  
*Turning a Weakness into a Strength: A Smart External Energy Policy for Europe*, Coby van der Linde, (EN) Paris, IFRI, April 2008, [Http://www.clingendael.nl/publications/2008/20080400\\_ciep\\_art\\_linde\\_ifri.pdf](http://www.clingendael.nl/publications/2008/20080400_ciep_art_linde_ifri.pdf)

contractual relations is guaranteed. The EU has lately discovered that EU crisis policy in the case of market disruption or failures is essentially a test of national crisis capabilities. In energy it is not much different than arrangements in the financial markets and is at best not more than coordination of national efforts. The risk asymmetry in certain parts of the EU energy market can currently not be corrected by a more symmetric burden sharing, helping those parts of the EU market most affected. That is where smart energy policy can make a difference. If for instance energy does not flow through the gas pipeline infrastructure can the flow of electricity compensate for some of that loss and can the use of other fuels quickly overcome the supply disruption. That should be the focus of European energy policymakers and stimulate investments accordingly.

### **In Conclusion**

It is clear that more transparency in energy supply and demand matters in general, including the macro-economic drivers, investment policies, energy mix policies and strategies on all sides, are highly desirable in order to continue and to secure stable and mutually beneficial relations. Especially periodic information exchanges for oil and gas production, transportation needs and planning would require new mechanisms for joint monitoring and discussion. It is important that trust on all sides is improved. The EU wants to build up confidence that sufficient investments in production and transportation is being built, while Russia wants the confidence that when they sell gas to the EU markets that this gas can reach the market. The Ukraine wants to retain its position as an important transit country of Russian and perhaps some Caspian gas to the EU, despite the alternative routes under development. For this, it needs enough Russian supplies finding a market in the EU. It is clear that the interdependencies will remain, but it is also clear that energy security in Russia, the Ukraine and the EU will improve if they all cooperate, and create structures that enhance cooperation, rather than let their energy relations spiral down, and create energy insecurity of all.

As long as suspicions abound between all three crucial partners, an early warning mechanism on short-term and unforeseen disruptions in energy supply could help to build further confidence. In addition, EU-Russia-Ukraine energy relations offer many prospects for mutually beneficial projects, including at regional levels, in energy efficiency and limiting gas flaring activities. The energy relations should also take the wide diversity of the role of Russian gas in the national energy balances in the EU into account. Inter-EU mechanisms for information sharing on projects for energy supply from Russia, including on the various necessary infrastructures, and on expanding internal solidarity devices in case of regional supply emergencies, would strengthen the effectiveness of the EU-position in forthcoming negotiations on new partnership arrangements with Russia and its energy relations with the Ukraine.