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Briefing note on the gas crisis of 2009

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The gas row

After a long period of fruitless negotiations, the dispute between Russia and Ukraine broke out in January over the basic conditions of gas supplies, including the price paid by Ukraine and the transit price charged by Ukraine to Russia. Ukraine's Naftogaz still owed debts and penalties of more than $600m for unpaid gas deliveries in November and December 2008 which triggered Gazprom to cut gas supplies to Ukraine. Naftogas claimed it had paid its debt but the two sides failed to agree on the price Ukraine should pay for gas as of 2009. Moscow initially wanted to raise its prices and charge Kiev $250 per 1,000 cubic metres, up from $179.5 last year. Ukraine thought that excessive and refused to pay more than $201. Russia promptly put its price up to $450 (which is still lower than the commercial price paid by many EU states but more than double of what Belarus pays).

Pointing to Ukraine's debt and penalties Russia decided to suspend gas supplies to Ukraine as of 1 January but initially maintained gas exports to the EU through Ukraine. The pipeline via Ukraine represents 80% of overall European supply, while a smaller pipeline goes through Belarus to Poland. However, gas supplies were reduced and later completely halted from 7 January (with the explicit political approval of Prime Minister Putin), after Russia accused Ukraine of siphoning off gas meant for European customers. Ukraine's Naftogas denied the charges but later also demanded that the technical gas required to maintain the pressure in the pipeline system should be provided by Russia for a discounted price. The situation left more than a dozen countries without their expected supplies of Russian gas. Some EU member states, such as Bulgaria and Slovakia were particularly hard hit but others faced some significant disruptions too.

The crisis erupted despite a memorandum of understanding signed by the prime ministers of Russia and Ukraine back in October 2008. This memorandum set out direct, long-term contracts and gradual price increases, bringing Ukraine's purchases of Russian natural gas to European market prices within three years. It also laid out a direct contract without intermediaries which is of key importance given the opaque role of gas trading company RosUkrEnergo.

Following mutual accusations by both sides and diplomatic efforts by both the Commission and the Czech presidency, supported by key European capitals, a deal was reached on 11 January, whereby EU and Russian observers would have monitored supplies across Ukraine while Russia agreed to restore deliveries immediately. However, this collapsed rapidly as Kiev added a hand-written annex to the agreement asserting that Ukraine did not steal gas earmarked for Europe and demanded that Russia should provide the technical gas related to gas transit. It also declared that Ukraine had no outstanding debts to Gazprom. Ukraine later withdrew the annex but gas deliveries could still not restart. Russia claimed that Ukraine shut down the taps while Ukraine claimed that it could not ensure the flow of gas for two reasons: the low volume of Russian gas and the technical difficulties associated with the transit route insisted upon by Russia, which threatened the supplies to the eastern regions of Ukraine.

European efforts towards a solution

Both the Commission and the Czech presidency undertook intense diplomatic exchanges to bring the parties together in order to find a solution. In lack of a legal basis (the contractual relationship was between companies and the coordination of energy policies remains weak at European level) or a clear mandate the European Commission was cautious and pointed out that its efforts to find a negotiated solution should not be called "mediation". It was clear that the crisis grew well beyond a simple commercial dispute but the EU was ill-equipped to deal with the issue efficiently at European level.

Gazprom and the Russian government were conducting an intense communications campaign and Ukrainian officials noted that they did not wish to participate in a PR war with Russia. While the Commission acknowledged Kiev's efforts to maintain transparency and share information, some statements made it clear that Ukraine had contractual obligations to provide the technical gas which was one of Ukraine's main reservations.

The Commission strategy was based on trying to establish an objective account of events and avoiding taking sides in the dispute while maintaining the pressure for a quick negotiated outcome. A key challenge therefore was to fully understand the course of events, including the technical and legal details and to introduce a degree of transparency and accountability in the politically charged debate. In order to restore a minimum level of transparency and trust, the Commission, supported by German Chancellor Merkel suggested sending a monitoring team to gas pumping stations. This strategy failed to bring about a breakthrough for two reasons: it proved impossible to separate the issues of transit from the price paid by Ukraine as the EU hoped and the EU also underestimated Moscow's and Kiev's willingness to raise the stakes even further. During the end game the EU still had limited means to press for a solution and could only encourage European companies to file lawsuits.

It is worth reminding that the European Parliament also tried to play a constructive part and on 8 January the Foreign Affairs Committee organized a joint meeting with the Russian and Ukrainian interparliamentary delegations and invited Naftogas and Gazprom as well as government representatives to confront the issues at a public meeting. The Russian representatives did not show up (due to travel disruptions) but Gazprom chairman Alexei Miller was already in Brussels in intense negotiations with the European Commission and more talks followed between his side and his counterparts from Ukraine. MEPs emphasized the political significance of the events and called on both parties to honour their contractual obligations and commitments. They also reminded that Russia and Ukraine were both damaging their reputation as reliable partners and that the Parliament's own initiative report "Towards a Common Foreign Policy on Energy" (Saryusz-Wolski report, 2007) addressed the kind of challenges that the EU confronted in January 2009.

The agreement

On 18 January Prime Ministers Putin and Tymoshenko reached a deal on restoring gas supplies to Europe and Ukraine. The agreement defines the price for 10 years, so it is theoretically a long-term a solution. Under the deal, Ukraine will buy Russian gas at a 20 percent discount to European market prices in 2009 (which is defined by a formula linking gas prices to the world market price of oil). This means that the new price for Ukraine will be around $360 per 1,000 cubic meters (cm) in the first quarter of 2009, significantly more than the $179.5 Kiev paid last year. Deputy CEO of Gazprom, Alexander Medvedev, said that the average price expected for sales to Europe this year is expected to be $280 per 1,000 cm. In a separate statement, Ukraine's Prime Minister said that her country would pay an average of $228.8 per 1,000 cm (a discount of just under 19%) through 2009. The contract will move up to the European average from January 2010. For the so-called technical gas, Ukraine will pay an average price of $153.9 per 1,000 cm. The transit fee of $1.7 per 100 km will remain unchanged for this year but will move up to the EU average of $2.5 per 100 km from 2010.

The agreement also foresees the elimination of "intermediaries" in gas trade. This refers to RosUkrEnergo, the intermediary company that is co-owned by Gazprom and a small group of Ukrainian businessman. Many of the disputes between Russia and Ukraine over gas shipments and debts have been blamed on RosUkrEnergo whose dealings and role in financing politics through corrupt channels remained anything but transparent.

The economic significance of the agreement

Unlike for oil, there is no unique "world market price" for natural gas given the fixed supply routes and sources. Gazprom/Russia renegotiated contracts with many of its neighbours in a similar manner every year. The three main Central Asian gas producers (Turkmenistan, Uzbekistan and Kazakhstan) agreed a new gas deal with Gazprom from January this year (the overall amount of gas imported from the three countries is comparable to the volume of exports to Ukraine). They now get a higher price, comparable to the EU price less transportation (around $360 per 1,000 cm). This is a very substantial increase over previous years when each had separate deals with Gazprom. This new agreement also acted as a catalyst for Gazprom's demands to Ukraine. In previous years, Russia could pass on the cheaper gas it purchased from Central Asia to Ukraine and gained a decent profit. But from January 1st that cheap "input" gas is no longer available and that also forced Gazprom to push the issue with Ukraine.

This also means that as of 2009 Gazprom switched to a "more commercial basis" of pricing from a political one (with the exception of Belarus). Some analysts argue that this will help Gazprom's efforts to shift its market image as a partly commercial and partly political company another step towards the former which could also move it towards a better valuation basis relative to its global industry peers. Gazprom has always traded very cheaply on an asset basis because of the question mark over its ability to fully commercialize those assets (prices charged in domestic sales and exports are still different). Previously the opaqueness of the contract negotiations with Central Asia and Ukraine also contributed to a more negative image. All this means that in 2009 Gazprom will not be a financial winner as a result of the gas dispute but in the long term it may strengthen its strategic position. In the short term, however, Gazprom is struggling to maintain production levels and has significant debts while cutting back on vital investment in new projects and infrastructure. Some key projects might be cancelled but company representatives indicated that the Bovanenkovskoye gasfield in the Yamal peninsula, the Shtokman gasfield in the Barents Sea and the Nord Stream pipeline to Germany would not be affected.

Ukraine's capacity to pay a much higher gas price has been questioned by observers. A higher gas price could cripple Ukraine's economy (e.g. the steel industry), already hit hard by the slowdown. But analysts and officials said a substantial drop in market prices expected this year would bring down the average 2009 price to levels more affordable for Kiev. Nevertheless, if Ukraine begins to accumulate debts on gas payments, it could trigger a new round of disputes. The newly agreed gas price means extra costs for Ukraine in 2009. As of 2010 the country will benefit from a significant increase in transit fees and that could offset some of the higher energy bill. Ukraine will be in a very difficult situation if the price of oil and gas increases sharply. Nevertheless, this adjustment, however painful, is necessary in order to achieve long-term industrial competiveness given that an artificially cheap gas would conserve inefficiency.

Ukraine's economy has been hard hit by the global credit crunch, along with the falling price of steel that provides important export revenues. The International Monetary Fund (IMF) approved in November a $16.43 billion emergency loan to Ukraine. The country has already received $4.5 billion and a decision on the second tranche could be adopted in February. Recent press reports confirmed that Ukraine is also considering a loan from Russia and other countries to cover its budget deficit.

At the same time the Russian economy has also been hit hard by the crisis. It is to adjust its budget for 2009 on an assumption of a lower oil price ($41 instead of the previous $95). Forecasts for economic growth had to be revised, the government is planning a second wave of support to banks and the rouble has continued its sharp depreciation. Inflation may reach 13 percent in 2009 and capital outflows continue and may reach last year's level of over $120 billion. Russia's huge reserve fund built up in the course of the last few years has already been significantly depleted. Russia was also the first large emerging economy to see its credit rating downgraded.

Political aspects

A simple and strong argument to explain that the gas row was more than a commercial spat is that Russia lost more income during the twelve days of shut-off to Europe than it stood to make from any renegotiated agreement with Ukraine. This would suggest that non-commercial considerations could play an important role in Russia's behaviour.

Some analysts argue that Prime Minister Putin (called the "de facto head of Gazprom" by some reports) used Gazprom as a weapon to achieve political goals by means of "economic blackmail". His objectives included weakening and if possible removing President Yushchenko from power in Kiev, exposing Ukraine's unreliability as a transit country, making it clear to Europeans that they were dependent on the Kremlin good will for their energy and getting European support lined up for Gazprom's two new planned pipelines (Nord Stream and South Stream) as alternative routes to EU markets bypassing Ukraine. This would make Moscow gain in the long term at the price of a short-term commercial loss.

Whether orchestrated by Russia or otherwise, the gas crisis, coupled with the ongoing economic recession will have an impact on political life in Ukraine which is defined by a strong antagonism between President Yushchenko and Prime Minister Yulia Tymoshenko. Some argue that President Yushchenko played a role in triggering the crisis by preventing a last-minute attempt of PM Tymoshenko to mediate and ordered the Ukrainian delegation to break off talks on New Year's eve. He was much less involved in the flurry of talks than Prime Minister Tymoshenko and indicated before the signing that he was not satisfied with the terms of the agreement. His advisors talked of a possible review of the deal, stating that it favoured Russia's interest over Ukraine's. He recently reassured President Barroso that he would not challenge the agreement. Yuliya Tymoshenko might try to use her role in reaching the agreement to boost her popularity and strengthen her image –paraphrasing press reports - as a 'can do' leader. As a result Mr Yuschenko may suffer further setbacks ahead of important parliamentary and presidential elections.

Implications for the EU's relations with Ukraine and Russia

Both Russia's and Ukraine's reputation suffered a significant hit and relations have been strained. However, they should not be permanently damaged and energy relations on their own should not undermine efforts to move forward in relations with both countries. The responsibility for the gas crisis is very difficult to establish clearly as it seems to be shared by both countries. The gas crisis should of course have a significant impact on energy cooperation but it would not be the EU's interest to fundamentally review relations merely in light of the January events.

Negotiations for a new agreement should continue both with Russia and Ukraine and with Russia they will undoubtedly take a long time to complete. It is clear that the EU will push even more than before for legally binding guarantees in energy relations. The recent meeting in Moscow between Russia and the European Commission (with President Barroso and 9 commissioners present) also confirmed that there is a wide range of issues where tensions exist, including human rights, the rule of law and EU concerns over Russia's plans to establish military bases in Abkhazia and South Ossetia.

Commenting on the prospects for future EU-Russia cooperation in the energy field Russian Prime Minister Vladimir Putin said on 6 February that "Russia is ready to take into account the energy interests of the EU member states, but expects the same attitude from the Union". Future cooperation in the energy area between Russia and the EU should be based on respect for the same rules, he explained, calling for the immediate renegotiation of the Energy Charter Treaty that Russia refuses to ratify. Russia is of the view that the ECT is unbalanced in protecting consumers over suppliers. Prime Minister Putin recalled the recent proposal put forward by President Medvedev at the recent Davos summit. Interestingly Russia also claimed during the gas row that Ukraine did not respect its transit obligations as signatory of the ECT. Russia also welcomed prolonging the stay of the gas observers until the end of the first quarter of 2009.

Ukrainian leaders' statements also reflected that they did not believe Ukraine's reputation or relations with the EU had been damaged. "I would say that the gas crisis even makes the impetus for integration stronger," President Yushchenko said, expressing the hope that the EU and Ukraine would sign a free trade agreement and a common air space accord this year. Ukrainian ambassador Andriy Veselovsky said he is convinced that the gas crisis will by no means influence talks on an association agreement and the creation of a free trade zone.

The recent Troika meeting with Ukraine on 4 February showed that relations did not suffer a setback. The meeting covered prospects for Ukraine's further integration in the EU energy space, particularly, Ukraine's accession to the Energy Community Treaty and the holding of an international investment conference on the modernization of Ukraine's gas transportation system in March. Approximately 2.5 billion euro is necessary between now and 2013 to maintain the current transit capacity according to an EU-funded study.

Commissioner Ferrero-Waldner said that "The upcoming international investment conference on the rehabilitation and modernization of Ukraine's gas transit system which will be co-chaired by Ukraine and the Commission is proof of our commitment to assisting Ukraine in being a reliable partner in the field of transit of energy resources". The meeting also touched upon the implementation of the agreement on the liberalization of visa regulations between Ukraine and the EU.

Consequences for EU energy policy

Russia will undoubtedly use the crisis as a pretext to strengthen support for the Nord Stream and South Stream gas pipelines. Meanwhile the EU may have found a new impetus to speed up the Nabucco project following the Budapest conference. The European Commission announced a 250 million euro support in the form of a risk-sharing facility together with the European Investment Bank that would help raise loans for the project. This is not a large proportion of the estimated 8 billion euro overall cost (this figure may be reviewed in light of recent cheaper steel costs), nevertheless Commission support may mean an important step forward.

As part of the 5 billion euros of unspent money to go on infrastructure spending, the Commission proposed to support a range of projects to promote the development of energy infrastructure and the EU's internal market as well as to encourage both diversity of energy sources and supply routes. The March European Council meeting will also set out measures in order to make the EU better equipped to deal with similar crisis situations in the future.

The EU will also complete the Third Single Energy Market package which is currently in its final stages. This will mean more transparency for networks, storage and demand. The Commission will also propose changes in the Security of Gas Supply Directive, another piece of the puzzle to boost energy security.

The crisis has also further upgraded the importance of Central Asia and the Caucasus for the EU. In this context the political importance of the EU's new Eastern Partnership has also grown.