

Deflating Russia's Gas Pressure

The contest between the EU and Russia over their neighbourhood has intensified. The future of Ukraine is the coveted prize. Moscow is determined to thwart Ukraine's drift towards the EU. Yet, even as Moscow still holds many cards, the EU is well positioned to counteract Russian pressure head on.

by Jonas Grätz

Since 1990, Russia and the EU have had different visions for their common neighbourhood – yet rarely has this contest of influence been as tense as today. Whether Ukraine, as the biggest and most important country in the region, stays in the East or moves towards the West, will decide the outcome for the region as a whole. Whereas Russia wants to integrate Ukraine into its Customs Union, the EU has crafted a far-ranging Association Agreement.¹

Traditionally, the EU has relied on its long-term, gradual, and technocratic policy approach – focused on harmonising standards, implementing the rule of law, and demanding democratic reforms in exchange for freer trade. In contrast, Russia has used short-term economic pressure to remind Ukraine of its impressive economic leverage as a gas supplier and market for Ukrainian goods. Yet both approaches have not paid off in full: Whereas Kyiv's elite resisted democratic changes demanded by the EU, Russia's blunt pressure has alienated the elite and public alike. The good news is

that Russia's assertiveness has opened a window of opportunity that Brussels can exploit if it adapts its approach. To do this, the EU should ensure that the disputed Association Agreement will be signed at the Eastern Partnership's Vilnius summit this November. At the same time, the EU

KEY POINTS

- Russia's and the EU's development models for their neighbourhood diverge increasingly, taking on the character of a zero-sum game
- Moscow's assertive actions against Ukraine have opened a window of opportunity for the EU
- The EU should ensure that the Association Agreement with Ukraine will finally be signed at the Vilnius summit
- Yet, the EU has to do more to take the edge off Russian pressure
- Ironically, Brussels can do this by taking four steps exactly where Moscow is deemed strong: in the natural gas sector

should look beyond Vilnius and take four concrete and short-term steps to deflate Russia's gas pressure.

A window of opportunity

Ukraine is considered crucial both by the EU and Russia – for different reasons. On the one hand, after two decades of seeing the EU (and NATO) expanding eastwards, Russia is set to stop this development and protect its sphere of influence. For Russian elites, keeping Ukraine on a development path similar to their own is vital, as it serves to underpin their own concept of Russia as the centre of a “civilisation” distinct from the West. The Putin administration therefore intends to stabilise the economic pattern of Ukrainian energy dependence on Russia and the traditionally strong integration of heavy industry, inherited from Soviet times.

For the EU, on the other hand, Ukraine is important both as a symbol of its success model of peaceful reform of governance and as a strategic energy hub. Ukraine possesses the largest gas transit system and gas storage sites on the European continent, which could well be turned into a vibrant hub for gas trading.²

Russian control over this vast infrastructure would substantially increase Moscow's capacities to manipulate vital industries in Ukraine, as well as the liberalised gas market of the EU. Thus, Brussels' energetic efforts to diversify and reduce its energy dependency, and gain geopolitical freedom of action, stand or fall with Kyiv's choices.

The EU revealed its increasing ambitions when it launched the Eastern Partnership initiative in 2009. The policy offers mechanisms for internal transformation and closer integration with the EU to Belarus, Ukraine, Moldova, Georgia and Azerbaijan. In response to this, the Kremlin intensified its drive towards re-integration of the post-Soviet space. Kazakhstan and Belarus joined Russia's Customs Union in 2010. Kyrgyzstan, Tajikistan and Armenia are about to join, driven by fear of a lack of access to the Russian labour market. And Moscow played its energy-card successfully: Russia subsidises Belarus with cheap energy as a quid pro quo, but in all other areas Russia's economic interests are in the driving seat, be it external tariffs or control over vital industries. Now, the Kremlin wants to replicate its “Minsk masterstroke” in Kyiv. Altogether, this competition between the EU and Russia has taken on a zero-sum character, as the goals of Moscow and Brussels are impossible to reconcile.

However, the final decision over the outcome will be made in Kyiv alone – and here the timing is favorable for the EU. Being aware of Belarus' fate, the Ukrainian

KEY FACTS

Gas is Ukraine's most important energy source, providing leverage to Russia. In 2012, Ukraine imported 60% of its demand of 54.8 billion cubic meters (bcm) from Russia, at an excessive price of US-\$ 425 per thousand cubic meters (for comparison: Germany paid US-\$ 387 on average for its gas imports). But Ukraine has the capability to import 36.8 bcm annually from the EU – most importantly via Slovakia with 30 bcm/a.

Ukraine possesses substantial natural gas assets: in addition to the largest transit capacity in Europe, its storage capacity, crucial for balancing between summer and winter demand, stands at weighty 34 bcm – the EU's entire capacity is only 78 bcm.

Yet, Ukraine's economy is trade-dependent. Its export structure lends leverage both to Russia and to the EU: In 2012, the Customs Union accounted for a third of exports, whereas 22.6% went to the EU. The EU has a strong leverage in the steel industry, which stands for over one third of Ukraine's total exports. Russia has leverage in higher value-added sectors such as machine building, as it buys two thirds of the output. But Russia sells mostly hydrocarbons to Ukraine, which account for almost one third of imports. In contrast, imports from the EU are dominated by high value-added products such as machinery and chemicals. They amount to a third of Ukraine's imports.

elite has not been keen on integrating with Russia. Nevertheless, it has not embraced the EU's agenda so far either, preferring instead to waver between Moscow and Brussels. However, it now begins to realise that this policy has brought diminishing returns and is at a dead end. First and foremost, giving Moscow's overtures a cold shoulder comes at a cost: Ukraine pays almost thrice as much as the more compliant Belarus, letting its gas payments to Moscow amount to 8% of its GDP. In addition, Russia regularly engages in economic warfare, frequently blocking imports of certain goods, such as meat, dairy, or even chocolate. On top of this, it practically halted all imports from Ukraine by severely complicating the customs clearing procedure in mid-August. While these acts of pressure have weakened Ukraine economically, they consolidated it politically – and made it receptive to EU proposals.

To sign or not to sign...

Against this background, the impending Vilnius Summit presents a unique – and maybe the last – opportunity to Brussels and should be seized by signing the Association Agreement with Ukraine. Sure, this will face heavy criticism: Intra-EU opponents of the signing emphasise that Ukraine will likely not fulfil all preconditions set by the EU and signing would thus decrease the EU's leverage. This argument rests on two assumptions: the EU has substantial leverage over Ukrainian elites as of now, and it will

have substantial leverage in the future, if it does not sign the agreement. However, these arguments do not withstand closer scrutiny: Ukraine's political elites and "oligarchs" have so far cherry-picked reforms that suited them. Leverage has been low as the EU's carrots have been long-term and a realistic membership perspective is lacking. In sum, conditionality, the EU's main instrument to effect change, has not been all that efficacious anyway.

The current timing is favourable for signing, as the political situation in Ukraine has changed in favour of the EU, and its leverage is likely to be at its strongest. However, Brussels has to brace for Moscow's reaction. As one of the EU's largest energy suppliers, the worst-case scenario would be a gas cut-off to the EU – an overreaction that would likely be short. Unlike oil, gas is not an indispensable fuel. A gas cut-off would thus backfire on Russia, as it would discredit natural gas as a primary energy source in Europe. Thus, while Moscow's precise reaction is difficult to predict, the EU should grasp the political opportunity and sign.

Beyond Vilnius: Four concrete policy steps

Signing the Association Agreement is crucial – it will, however, not be a panacea. The EU will have to take concrete measures to curtail Russia's traditionally strong position in Ukraine's gas sector.

Ironically, it is precisely in the gas sector that the EU is stronger than it thinks – if it plays its cards swiftly and decisively. It is the shattering economic crisis – another irony – that, coupled with the shale gas "revolution" in the US, has the benefit of leading to a substantial surplus on the EU gas market. Lower prices mean that gas deliveries from the EU in reverse flow from West to East have become an attractive economic proposition. Thus, for the first time, Ukraine now has a clear short-term incentive to adopt EU rules in the energy sector that would make it part of the EU's gas market. Ukraine has already joined the EU's Energy Community Treaty in 2011.³ It obliges Ukraine to facilitate gas market access and greater transparency. Even though oligarchic interests in Ukraine, and a wary eye towards Moscow, delayed the treaty's implementation, success is now more apparent than in other fields. The EU should build on this success and exploit it, with four concrete policy steps.

First, the EU should work swiftly to remove internal obstacles for reverse flow of gas to Ukraine. This would reassure Ukraine that sufficient gas can be sourced from the EU market. Whereas small amounts are already being supplied via Poland and Hungary, far greater capacities are available in Slovakia. Alas, since Prime Minister Fico took office in April 2012 and a Czech-Slovak entity

took control of the pipeline, Slovakian gas transit to Ukraine has been a non-starter. Instead, an unnecessary additional pipeline to Ukraine was proposed as a smoke-screen and the transport tariff has been hiked. The EU Commission and member states should thus step up pressure on Slovakia to honour its commitments and facilitate transit. After all, this should be an attractive proposition, as it would mean additional revenues for Slovakia. EU energy companies such as RWE have already reassured Ukraine that they are willing to supply more gas, once the obstacles have been removed. EU member states should seek to use their contacts in energy companies to encourage them to trade with Ukraine.

Second, with the carrot of enhanced supplies in hand, the EU should push Kyiv towards swift implementation of its obligations under the Energy Community Treaty. This would also remove obstacles to supplies from the EU on the Ukrainian side. As the EU has short-term remedies to Kyiv's grievances, and considering that implementation offers real opportunities such as Ukraine's transformation into a gas hub, the effect is likely to be immediate. The Energy Community Treaty and its opportunities have also caught the attention of civil society actors in Ukraine. This development should be strengthened as it acts as a counterweight to the special interests holding back implementation.

Third, the EU should give full support to the modernisation of Ukraine's pipeline system, as had been stipulated in 2009.⁴ The EU should try to get Gazprom on board – but only as a financial investor. It will not be feasible to wait for throughput guarantees from Russia. Rather, the best throughput guarantee is to prevent bypass pipelines such as South Stream from being built. A key point is that bypass routes do not enhance security of supply, since

FURTHER READING

Energy Dependency, Politics and Corruption in the Former Soviet Union

Margarita Balmaceda (Routledge 2008)

A pathbreaking study, showing how Ukraine's energy dependence, corruption, and political inertia frustrated a rational policy and catered to Russia's interests.

Hard Diplomacy and Soft Coercion *James Sherr (Chatham House 2013)*

The new standard in content, prose, and analytical clarity on Russia's influence abroad – and how to develop remedies.

The Ukrainians: Unexpected Nation *Andrew Wilson (Yale University Press 2000)*

Still the classic monograph explaining the legacy of Ukraine's (unfortunately) prevailing identity problems by discussing them in their historic context.

gas is taken from the same sources and these routes lack sufficient storage to meet peak winter demand, as experienced in 2012. Hence, the pipelines do not fulfil crucial conditions for exemptions from EU regulations.

Fourth, the EU and its member states should coordinate with Washington and rapidly conclude the Transatlantic Trade and Investment Partnership (TTIP). This would make exports of Liquefied Natural Gas (LNG) from the US possible without further action from the respective governments. At current gas prices in the US, exports would clearly be profitable, and markets would react. US gas exports would not only underscore the robustness of the EU's gas market, but also help to alleviate possible supply cuts.

Brussels' structural difficulties in conceiving and implementing a coherent foreign policy are well known; yet, if the EU wants to shape its critical Eastern neighbourhood, it has to seize the opportunity and take swift and concrete policy steps. The looming alternative is that Kyiv will have no choice but to bend to Moscow's pressure. This would lead to a loss of political plurality and to economic instability in Ukraine, and would jeopardize the EU's energy security. However, the implementation of the four steps detailed above, built on the momentum of a signed Association Agreement, could decisively tip the balance in Brussels' favour, at a reasonable effort and with acceptable uncertainty.

By doing so, the EU would stay in the game, lower the pressure on Ukraine and make a big step towards being a geopolitical power to be reckoned with.

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Dr. Jonas Grätz is a Researcher with the Global Security Team at the Center for Security Studies, ETH Zurich. The views expressed here are the author's own. <http://www.css.ethz.ch/people/CSS/jgraetz>

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Editor: [Martin Zapfe](#) / Assistant Editor: [Prem Mahadevan](#)

Comments welcome at PolicyPerspectives@sipo.gess.ethz.ch

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