

Analysis

Europe Held Hostage?

By Kirsten Westphal, Berlin

Abstract

The current Russian-Ukrainian “gas war” caused a complete halt in the delivery of natural gas from Russia, through Ukraine, to Europe. In particular, the conflict cut off South Eastern Europe from natural gas deliveries. Extending more than twelve days, the situation is unprecedented. Europe finds itself a hostage and victim of an ostensibly commercial dispute. Despite its desire to remain on the sidelines, Europe felt obliged to engage in the bilateral conflict and take a position. This article explores the extent of the EU’s room for maneuver and the instruments it can bring to bear in resolving the crisis and its original causes. The very nature of the Russian- Ukrainian gas dispute is structural, meaning that its resolution requires European political action to address long-term issues. To be effective, the EU has to tackle the problems constricting its gas imports on different levels: bilaterally with Russia and Ukraine, internally within Europe, and internationally with a host of multinational players. No simple remedy will work, so the EU has to rely on a set of measures and tools that comprehensively address energy, foreign, and economic policies. The need for multilateral energy governance on the continent is more acute than ever. All other measures will become effective only in the medium or long run.

An Unprecedented Gas Cut-off

At first glance, the dispute seemed to be commercial and a repeat of the 2005/2006 clash. However, the results of the current disagreement are much more dramatic and have left EU member states and member states of the energy community in South Eastern and Central Europe without gas deliveries from Russia. Industrial users face severe rationing while residents of Slovakia and the Balkans lack sufficient heating. Even Russia’s largest consumers on the continent, Germany, France and Italy, must deal with shortages.

The “gas war” that turned off the taps on January 7, has likewise become a “PR-war,” with both sides trying to convince the international community that their actions are justified. Although each side has described many technical details to make its case, key facts remain obscure. What persists though is the international bewilderment about the stubbornness of both sides. That hints at underlying realities and structural problems.

The financial crisis has hit both countries, aggravating the economic side of the struggle. The hard-fought domestic power struggle in Kiev between President Victor Yushchenko and Prime Minister Yulia Timoshenko, particularly over the future role of the intermediary company Rosukrenergo, shapes part of the political dimension. The short-term logic driving the political elite on both sides derives from personal interests, corruption and rent-seeking strategies. The involvement of intermediary companies and other business interests makes it difficult to settle the bilat-

eral Russian-Ukrainian dispute on rationale economic terms. Moreover, the general geopolitical landscape functions as an impediment to “smooth” conflict resolution, as Moscow has no incentive to accommodate Ukraine with a gas delivery agreement. Ukraine took a clear stance in the Russian-Georgian war, appealed to join NATO and left open the future deployment of the Russian Black Sea fleet after 2017, among other points of dispute with its eastern neighbor.

The dispute between Gazprom and Naftohaz Ukrainy grew intense in November–December 2008 over old debts and new prices. By New Year’s Eve, no agreement for gas deliveries from Russia to Ukraine in 2009 was in place. The Russian side used this situation as a justification to diminish gas volumes delivered to Ukraine, seeking to send Europe’s gas through the pipeline while depriving Ukraine of any flows. In the following days, mutual recriminations resulted in a deadlock, and from 6–7 January on, the gas pipelines went dry. Gazprom cut off the supplies after Prime Minister Vladimir Putin gave the public order to do so. An EU gas monitoring mission that began working on January 11–12 did not achieve the much needed break-through. From January 14 on Russia made several attempts to send 99.2 mcm of gas to the entry point at Sudzha, but Ukraine refused to transport it for technical reasons. An accord was reported on January 17, as a result of bilateral negotiations between the two prime ministers. Whether this deal provides the much needed substantial break-through remains to be seen not only in the short-term but also in the long-term.

The EU's Limited Leverage

Gas deliveries to Europe have been taken hostage in the dispute between Russia and Ukraine, as EU Commission President Jose Manuel Barroso has lamented. Are the EU's hands tied politically as well?

Given the brewing humanitarian crisis in South Eastern Europe, German Chancellor Angela Merkel put forward the idea on January 7 of establishing a monitoring mission composed of European, Russian and Ukrainian experts. The monitors deployed on 11–12 January, but have not brought the conflict to an end so far. Other attempts by the European side to broker a comprehensive deal have failed so far.

Both Ukraine and Russia have lost credibility as being able to supply and ship natural gas. But, once the crisis is over, in the short to medium terms, this loss of reputation will have no real consequences on the actual gas flows from Russia through Ukraine thanks to the geographic and infrastructural realities on the continent: in terms of physical flows, there is no alternative to gas from Russia via Ukraine. Supplies from Russia make up 42 percent of EU-27 gas imports. Gas consumption in Europe will most likely trend upward by one percent a year as Europe replaces coal with gas for environmental reasons, according to the forecasts of the International Energy Agency. European neighbor Russia has the world's largest gas reserves, with more than a quarter of the global deposits. Europe's own reserves are running out, so the two are bound together. Moreover, currently all Russian exports outside the CIS are directed toward Europe. Gas sales to Europe account for the vast majority of Gazprom's income. Moreover, Ukraine is still the most important transit country, as 80 percent of all exports from Russia pass through this former Soviet republic. The existing alternate pipeline routes transport much smaller volumes: the Yamal-Europe pipeline carries only 33 bcm/a and Blue Stream transports just 16 bcm/a to Europe.

Moscow and Kiev may have calculated that situation thoroughly. Even economic losses from unrealized gas sales and transit services are relative. Many European customers have used gas from storage which has to be replaced later (by Russia via Ukraine), presumably at lower volumes, maybe at falling prices. Moreover, Gazprom has declared "force majeure" on the transit issue, claiming that it is not liable for non-fulfillment of contracts and shifting the burden of proof if any of its customers demand penalties. So far, not a single European gas company has announced court action.

In fact, the EU's political and economic leverage is very limited in the short-term. There is no remedy as

such, but the EU must put in place a set of measures and tools that together constitute a comprehensive energy, foreign, and economic policy.

The EU Tool Box

When it comes to the "small box" of tools that are related to energy security, EU measures will only have an impact in the medium to long run, that is from five to fifteen years. The need for a prudent and sustainable energy policy is more urgent than ever. Europe has focused on the demand side, concentrating on energy savings, energy efficiency, and diversification of the energy mix with a strong reliance on renewables. This approach builds on the assumption that the cheapest and most secure energy source is the one that is not consumed. And indeed, the European Union has been on the global forefront with its 20+20+20 formula, which calls for reducing greenhouse gas emissions by 20 percent from their 1990 levels, making renewables 20 percent of final energy consumption, and implementing a 20 percent savings in future energy demand by 2020. Implementation of this plan will make a significant contribution to increased energy security in the future. Of course, gas will remain a major energy source for ecological reasons.

In terms of narrow energy security, diversification is the key. The first dimension of diversification concerns the energy mix, which can be broadened by new sources of fuel such as biogas. The other dimension concerns the diversification of supply, requiring new suppliers and alternative import infrastructure including LNG facilities. In that respect, the Southern, or fourth, corridor from the Caspian Sea region and Central Asia has gained prominence in the debate. The current gas war shows that new infrastructure projects are needed and the Nabucco pipeline has already received more support. In contrast, the Nord Stream pipeline project is viewed more critically, mainly because Russia, the only supplier for Nord Stream, plays a prominent role in the current crisis. The Russian leadership has made a major point over the last year that it seeks direct access to European markets.

Both infrastructure projects, however, highlight the incoherence of European energy policy. Despite the fact that both projects have been identified as TEN-E projects, both are delayed in their implementation, and questions about their feasibility abound. Many observers argue that the EU should not only identify strategic transport corridors, but should also improve its own financial and political instruments to realize them. The idea of Brussels as a broker for energy projects which

require business consortia at all stages of the project, has been widely discussed, but has yet to be implemented. Still, private energy companies are the main players in implementing supply-side energy security, and they compete with each other in the markets. The competencies of Brussels in respect to energy security are very limited since the EU has no common energy policy so far.

Europe in Search of Solidarity

The gas war is taking place shortly after the EU released its Second Strategic Review in November 2008. This current round of conflict likely will give greater emphasis to certain elements outlined in the document. The EU no longer sees energy security through a geopolitical lens, equating discussions of it with the lack of a common external energy policy. Instead, the EU now focuses on solidarity among the member states and expansion of the internal gas pipeline network, building new storage facilities and improving the exchange of information. In that respect, the gas dispute could push forward the Nord Stream pipeline, but with greater solidarity among member states, a concept that Poland originally proposed in response to the German-Russian deal on the Baltic Sea pipeline. Currently, the solidarity mechanisms that can be used are limited in scope, particularly regarding bidirectional pipeline links and storage facilities. The fact that spot market gas prices in Europe increased by a quarter from December 2008 to January 2009 reflects this problem. With the exception of a more coordinated exchange of information, all other envisaged measures will take time. The EU's list of tasks to be accomplished internally is already large and costly. Nevertheless, its energy efficiency goals should also guide its external policies toward Russia and Ukraine.

In its foreign relations, the EU has to focus on the bilateral issues at stake. The whole gas war reveals the murky gas relationship between Russia and Ukraine, bringing in gas supplies from Central Asia and using intermediary companies. In general, long-term supply gas contracts are among the most secret documents in the energy business. In respect to Russia and Ukraine, the situation is even worse as the principle of "*pacta sunt servanda*" is not the underlying rule or culture, so contracts do not have the force of law. The disagreement over debts and prices has resulted in new quarrels about transit arrangements and fees. The EU and its member states have to exert all possible influence bilaterally: Russia and Ukraine must settle the issue in a transparent and stable manner based on contracts.

Building Agreement between Russia and Ukraine

Negotiations over gas prices for 2009 are indeed difficult at a moment when gas prices are about to drop significantly. Russia and Ukraine have agreed that gas prices should gradually increase to European netback levels, that is European gas prices minus the respective transport and transit costs. European gas prices follow a complex price formula that is bound to oil prices with a delay of about six months. This is the reason why it is evidently difficult at the moment to agree on a price. In July 2008, the world saw oil peak at a price of 147 US dollars a barrel – at the moment the price is less than 47 US Dollars. Depending on the reference date, both countries can make an argument for their preferred price. If no clear formula is fixed, the price could be anything from 200 Euros to 450 Euros per thousand cubic meters. Moreover, Russia has locked itself into contracts with Central Asian countries with gas prices of around 300 Euros for Central Asian gas. Simply put, agreeing to a "European price level" is not enough; what is needed is a more detailed formula that can be oriented to the so-called Groningen price mechanisms in Continental Europe. However, other formulas are possible, but they should be comprehensible and not be subject to regular re-bargaining.

In regard to transit issues, the question is how to handle transit fees and transport costs, which have emerged during the dispute, in particular in respect to the technical gas that is needed for the operation of the pipelines. If transit fees should cover technical gas, they should be linked to gas price developments. The transit issues cover the most tricky points in the whole dispute. Russia has tried since the early 1990s to take control via partial or full ownership of the Ukrainian transit pipeline system. The Russians have made such ownership a priority. Ukraine has resisted handing over the pipelines since independence as the pipelines represent a major asset in the yearly quarrels over gas supply volumes and prices, and a source of revenues. A proposed 2002 consortium between the two and involving German companies sought to modernize the trunkline system, but failed to materialize.

The EU Role

In this minefield, the EU has to act very carefully indeed. The EU has already been dragged into the dispute. However, there are several clear choices for transit regimes. Some separate transit fees from fuel costs, and customers on both ends of the pipeline have to pay for both. Other arrangements foresee a payment for "tran-

sit” in progressive gas volumes, depending on the actual volume that is shipped through the pipeline. This payment can be either “in kind” (gas itself) or “cash” (that is the actual price of the gas). What makes the Russian-Ukrainian case so difficult is that the regime has to be approved ex post with the whole interwoven transit and domestic pipeline network already in place. However, a clear transit regime is fundamental to solving the structural problems plaguing this major transit route.

Clearly, EU tools to fashion an early success are limited, but encompass first and foremost governance and regulatory initiatives. Nevertheless, critical observers point out that the EU has not invoked any of the institutionalized mechanisms so far. The complete halt of gas deliveries violates Article 7 (on transit) of the Energy Charter Treaty (ECT). Ukraine ratified this treaty, while Russia signed and has applied it, though has not ratified it. Transit issues lie at the heart of a long-term solution for European energy concerns. The EU is right to push negotiations on the Transit Protocol in the EU-Russia energy dialogue and the EU-Russian negotiations on the Partnership and Cooperation Agreement. The full application of this multilateral international regime would install dispute settlement mechanisms. It would be a first step to acknowledge the necessity of a multilateral regime if both sides invoked the conciliation procedure according to Article 7 (7) that the ECT provides.

The bitter fighting surrounding the “gas war” illustrates that structural reforms are needed in the energy sectors of both countries. The need encompasses not only modernization of the transport system and related facilities, which are on average more than 30 years old, but a much more efficient use of energy. This extraordinary potential can only be exploited if leaders demonstrate strong political will and provide financial resources. The EU is the first partner in this respect since it must address the broader economic and political picture but also *Ordnungspolitik* [regulatory politics].

In the aftermath of this unprecedented situation, the EU has to communicate clearly to Russia and Ukraine that this gas cut-off violated all signed bilateral documents, international practice, and the ECT, and destroyed credibility. There should be a full-fledged discussion of the rules, regulations and internationally-binding laws. The EU has put forward the idea of a pan-European energy community. The essential elements of the community are the extension of legal norms and free trade in electricity and gas, together with a harmonized regulation of demand according to the principles of energy efficiency and environmental and climate ac-

ceptability. The idea is to enlarge the common market, establish a legal foundation based on shared commercial and ecological norms, and put in place incentives that will tie the states of the Caspian Sea space, the Middle East, and North Africa to the European market by means of new infrastructure projects. And indeed, against the background of the current financial crisis, much needed funds have to come from the West, in particular in the case of Ukraine, but currently also in the case of Russia.

Regarding energy, Russia is the EU’s decisive counterpart on questions relating to political order, pipeline routes, and the goal of diversification, since the EU and Russia have different strategies on the central questions of policy. Harmonization of competition, non-discrimination and access to markets, infrastructure, and foreign investment are the central issues that arise, on a regular basis and in a variety of forums. The main bone of contention is Gazprom’s transport monopoly. In other words, Gazprom wants to own pipelines outside of Russia, but refuses to let foreign companies or governments own pipelines inside Russia. The EU and Russia are currently negotiating a new Partnership and Framework Agreement. The EU-Russia energy dialogue also provides another bilateral mechanism to negotiate energy issues. These channels have to be used now to address structural issues, such as the early warning mechanisms, which provide the possibility of engaging transit countries as well.

The EU has to put a stronger emphasis on energy infrastructure, but also pressure for more legal certainty in Ukraine. EU-Ukrainian relations are shaped mainly under the EU Neighborhood Policy (ENP) of 2004 and its Action Plans. ENP and other related activities (e.g. Black Sea Synergy) seek to extend the energy community, which came into existence on 1 July 2006 and includes both the EU member states and South Eastern European states, to Moldova and Ukraine and a few others.

What remains is the trivial conclusion that the most secure, cheap and climate-friendly energy source is the one that is not consumed. Estimates of the potential energy savings to be gained in the EU countries are greater than all the gas exports from Russia to Europe, potentially even twice as large. Energy efficiency paves the ground for cooperation. The EU has to put pressure on both countries to focus on efficiency. While the necessary investments will be costly now, they will pay off handsomely in the future.

(Information about the author and suggestions for further reading overleaf)

About the author:

Kirsten Westphal is a researcher at the German Institute for International and Security Affairs (SWP) in Berlin.

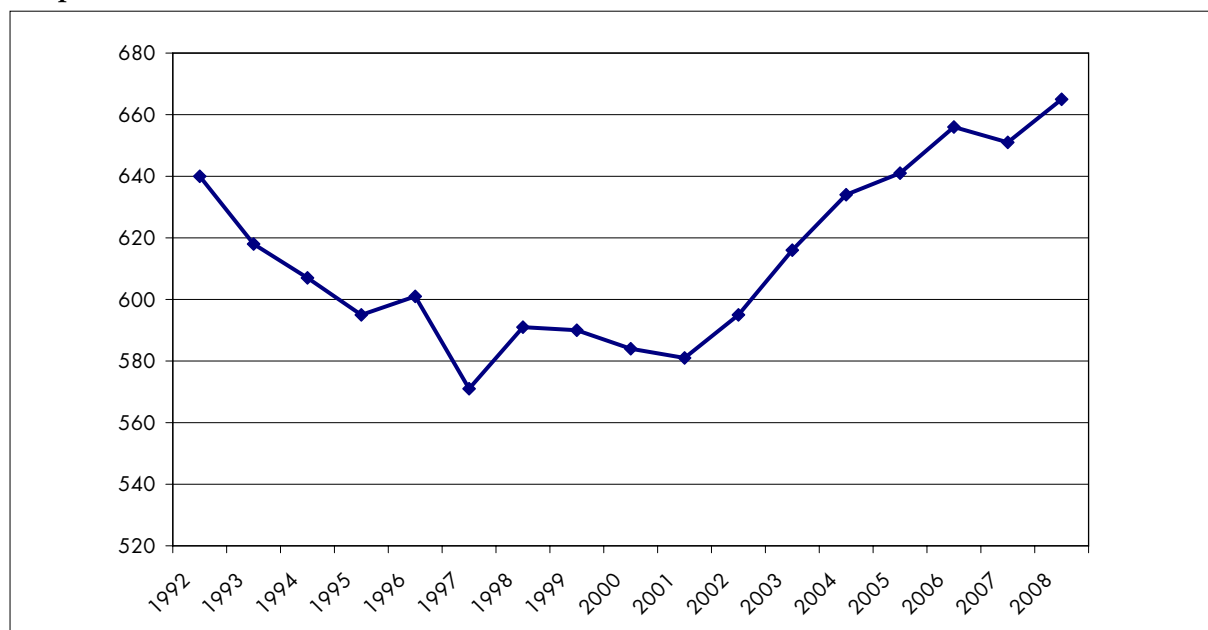
Further reading:

- Simon Pirani, Ukraine's gas sector, Oxford Institute for Energy Studies research paper, July 2007.
- Margarita M. Balmaceda, *Energy Dependency, Politics and Corruption in the Former Soviet Union, Russia's power, oligarchs' profits and Ukraine's missing energy policy 1995–2006*, BASEES/Routledge Series on Russia and East European Studies, 2008
- Kirsten Westphal, "Liberalised, Monopolised, Fixated, Antinomies of the European Energy Market, in: *The Europe beyond Europe. Outer Borders, Inner Limits*. Manfred Sapper, Volker Weichsel, Andrea Huterer (Hg.) (english reprint 2007)
- Kirsten Westphal, "Germany and the EU-Russia Energy Dialogue," in Pami Aalto, *The EU-Russian Energy Dialogue*, London: Ashgate 2008, p.93–118.
- Oliver Geden, Mehr Pragmatismus, weniger Geopolitik, SWP Aktuell 83, November 2008

Statistics

Russia's Natural Gas Industry

Graph 1: Russia's Natural Gas Production 1992 – 2008 (bn cubic meters)



Source: Russian Federal Service for Statistics, <http://www.gks.ru/dbscripts/Cbsd/DBInet.cgi>