Ukraine’s energy brinkmanship

In the fog of its foreign-policy confrontation with Russia over Ukraine, the European Union seems unable to see its energy-security interests clearly or to act accordingly.

Kiev has used the international crisis triggered by Russia’s actions in Crimea and eastern Ukraine to restructure the contracts with Moscow it signed in 2009. It wants a much lower price for its gas imports and the ability to swap gas with Gazprom’s clients in Western Europe. It also disagrees with Russia on the value of the gas debt that it has accumulated over the years. To obtain what it wants, Ukraine has engaged in a game of chicken that threatens European gas consumers. The EU should have responded quickly and strongly to such brinkmanship; instead, it has remained passive.

A looming gas crisis

After Russia cancelled various discounts it made in 2010 and 2013, and went back to the 2009 contractual price formula, Ukraine stopped paying for Russian gas in May 2014, before being cut off by Gazprom on 16 June. As winter looms, Ukraine finds itself in a situation that is somewhere between problematic and catastrophic. As a country with cold winters that is highly reliant on natural gas for residential heating, Ukraine receives between two-thirds and three-quarters of its gas from Russia in January and February. One-third of that is directly imported, while the rest (as much as half of total consumption at the peak of the heating season) is Russian gas that was pumped into underground storage facilities during the summer.

That Ukraine missed most of the storage-filling season in 2014 is a serious cause for concern. Not receiving Russian gas during the winter months would mean extreme shortages of energy.

Such shortages could lead to a repeat of the European gas crisis of 2009. Having failed to agree on a new gas contract with Gazprom after its earlier one expired in December 2008, Naftogaz found itself without Russian gas on 1 January 2009. At the time, Gazprom was still sending large volumes of gas through Ukraine to its clients in Central and Western Europe. From the moment it was cut off, Naftogaz began to divert gas from the transit pipelines to its domestic consumers. The escalation that followed resulted in Gazprom entirely shutting down the Ukrainian gas corridor for two weeks in the middle of a cold winter, which had serious implications for Central and Southeast European countries. A similar scenario could occur this winter, when Ukraine will face severe shortages.

Kiev was irresponsible to stop imports of Russian gas in June, as doing so put at risk both its own population and the citizens of Central and Western Europe who rely on the Ukrainian gas-transit corridor for part of their energy supply. Yet the EU failed to adequately respond.

Ukraine’s maximalist position

On 26 September, with the heating season approaching, the European Commission proposed terms for a winter gas deal at a meeting in Berlin. Under the agreement, Ukraine would pay back $3.1 billion of its gas debt to Gazprom by the end of the year (in two instalments), and would buy ‘at least’ 5 billion cubic meters (bcm) of gas from Gazprom between October and March, at a price of $385 per thousand cubic meters (tcm). The meeting was presented as a success, with the parties to iron out the details within days.

Our quantitative analysis shows that 5bcm is the absolute minimum needed to avoid a catastrophe, and would certainly not provide Ukraine with a comfort zone. Depending on how much gas has actually been stored away, Ukrainian storage facilities will be empty by sometime between late February and the end of March. However, unusually cold weather between December and February would ensure that the crisis occurred sooner. If a winter gas agreement included the option to take additional volumes beyond the 5bcm, as some have suggested, the situation would be significantly improved. But if Ukraine fails to sign an interim gas deal with Gazprom, a catastrophic situation could arise in which the storage facilities are empty by the end of January. Managing severe shortages so early in the winter would be extremely difficult, and might again result in the diversion of gas transiting towards Central and Western Europe.

Shortly after the 26 September meeting, it became clear that the parties were far from an agreement. At the time of writing, they had not met again as planned. It appears that Ukraine is sticking to a maximalist position.

The Ukrainian energy ministry stated that ‘during the negotiations, which took place on September 26, the Ukrainian side has not received an acceptable offer from the Russian side on the package’. The first issue is pricing. Ukraine wants the interim deal to be a standalone contract, separate from the ten-year 2009 agreement that contains a price formula it considers to be discriminatory and illegitimate. (Ukraine is suing Gazprom under the arbitration clause of the contract, in a bid to invalidate the price formula; the arbitral tribunal is scheduled to rule in mid-January 2015.) Russia, on the other hand, is willing to offer a discount of around $100/tcm, in the form of an export-duty waiver. The final price would then be $385/tcm under the 2009 contract, which Moscow regards as fully valid and in force.

The two parties also disagree on what the $3.1bn would pay for. Russia’s position – apparently consistent with the European Commission’s press release of 26 September – is that the sum would go towards repayment of the debt, a condition for Ukraine to buy the 5bcm of gas. However, the Ukrainian government maintains that $2bn would go towards the first tranche of the debt repayment, while the second instalment of $1.1bn would count towards payment for the 5bcm.

Most worryingly, Ukraine seems to have considerably widened the scope of the negotiation by asking that the gas-transit contract with Gazprom be restructured as a condition of the interim deal, purportedly to ensure that the arrangements were ‘in compliance with EU legislation’. Our understanding is that Kiev would like to be able to enter into swap deals, virtually giving Naftogaz access to Western Europe’s liquid-natural-gas terminals. Gazprom has consistently and successfully opposed such transactions along the transit pipelines carrying its gas westward, including the Yamal–Europe pipeline across Poland. There is nothing to indicate that progress is being made towards a deal, which is now a matter of urgency.

The EU must get tough with Ukraine

The European Commission has mediated the negotiations since spring, and facilitated gas flows from Central Europe to Ukraine. These gas flows will not replace Russian gas either this winter or in longer term, but they have helped Kiev maintain its maximalist negotiating position. Brussels has never denounced Ukraine's irresponsibility, nor does it seem to understand the impact of its own policies on Ukraine's negotiating behaviour.

It is now very late in the day, but what can be saved should be saved. The leaders of EU member states must regain the upper hand over the European Commission and deal with the situation in a manner consistent with Europe's energy-security interests. They should make clear to Ukraine that it has to go back to the 2009 contract to maintain its gas relationship with Moscow. It is unclear whether Kiev will be successful in its arbitration case against Gazprom, but it has no right to take Europe hostage as a means of forcing Russia to renegotiate their gas and transit contracts. Two specific messages should be conveyed to Kiev: it must agree to the terms suggested by the European Commission on 26 September and accepted by Russia for the winter interim gas deal, under the 2009 contract; and, if gas is diverted from the transit pipelines at any point during this winter, the EU Association Agreement with Ukraine will be immediately suspended, together with all programmes of economic assistance. It is the second message that will make Ukrainian ministers listen. Europe now has a lot of leverage over Ukraine, and it must use it.

The EU should fully embrace South Stream

The second pillar of Europe's strategy should be to complete the bypassing of Ukraine, ensuring that European energy-security is never held hostage to gas-price bargaining between Ukraine and Russia, as it was in 2006, 2009 and again in 2014. The governments of Germany, France, Italy, Austria, Bulgaria, Greece and Hungary (at least) should give Moscow assurances that the South Stream pipeline will be built. They should insist that the project will not de facto become part of the EU sanctions against Russia, contrary what was suggested in a recent resolution by the European Parliament. They should work towards a compromise with Russia and Brussels, over the regulatory objections of the European Commission towards the onshore sections of South Stream.

Bypassing Ukraine as a gas-transit country does not mean siding with Russia in the battle over the future of the country or its territorial integrity. European governments can continue to work, through large utilities and other energy companies, towards building South Stream while being as generous as they choose to be in their assistance to Ukraine, including in efforts towards energy diversification. True, Ukraine will lose its transit revenues when South Stream becomes operational, but the EU cannot force Russia to continue relying on Ukraine as a transit country, and it would be against the interests of Central and Western European countries to deepen the only serious risk to their gas-supply security. Moreover, a bypassed Ukraine would lose its leverage against Russia and therefore be in a much better position to make credible reform commitments to its international backers.

The security crisis in eastern Ukraine has raised the political price of cooperating with Moscow to discontinue gas transit through Ukraine. The prospect of a new gas crisis this winter, and indeed further crises every winter, shows that this is necessary nonetheless. The EU should act accordingly, publicly embracing the construction of South Stream as essential to its energy-security interests.

A foreign-policy test for the EU

Ukraine appears to be using the political crisis between the EU, the United States and Russia to extract economic concessions from Moscow through the restructuring of its gas contract. As in 2006 and 2009, its tactics rely on the assumption that Russia will be blamed if the dispute creates a gas crisis in Europe this winter. Such energy brinkmanship presents a serious foreign-policy challenge to the EU and its member states. So far, they are failing the test.

Chi Kong Chyong is a Research Associate in the Energy Policy Research Group, University of Cambridge.

Pierre Noël is Sultan Hassanal Bolkiah Senior Fellow for Economic and Energy Security at the IISS. An extended version of this essay will appear in the December 2014–January 2015 issue of *Survival*.

-This article has been originally published in *Politics and Strategy, The Survival Editors' Blog (IISS)*, October 2014