The Russia-Ukraine gas conflict and the geopolitical struggle for control of energy resources

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Soon after the signing of an agreement on January 19 in Moscow between the prime ministers of Ukraine and Russia, Yulia Timoshenko and Vladimir Putin, the supply of Russian gas to Europe was renewed. It had been halted on January 7 due to the conflict between the two largest post-Soviet states. However, the problems which led to an escalation of the conflict remain unresolved.

The natural gas dispute sharpened Ukraine's political and economic tensions, provoked a wave of anger in Europe and reinforced European desires to diversify its sources of gas. Although it partially achieved its goals, the Russian side did so at the cost of reducing its credibility as a supplier of gas and led in addition to significant economic losses for Russia's Gazprom.

As Ian Bremmer writes in the January 26 issue of the American journal *Foreign Policy*, "[T]he agreement on gas supplies that finally emerged will not create a foundation for longer-term improvement in Russian-Ukrainian relations... It won't be long before Russia and Ukraine are at it again—over energy supplies or something else."

In Ukraine, the most active advocate of reaching new agreements with the Kremlin has been Prime Minister Timoshenko. She represents the interests of those layers of the Ukrainian ruling elite who, while not renouncing the strategic goals of the pro-Western "Orange Revolution" of 2004, would like to avoid antagonizing the Kremlin and find areas of compromise between the two regimes.

Unlike Ukrainian President Viktor Yushchenko, Timoshenko is not striving for the country to become a member of NATO at any cost, nor does she support the efforts of the president to encourage anti-Russian moods. During the Russian-Georgian conflict over South Ossetia in August 2008, Yushchenko fully supported the Georgian Saakashvili regime while Timoshenko adopted what was, in fact, a neutral stance by refusing to issue direct statements about the events.

Having become prime minister of Ukraine in December 2007, Timoshenko has repeatedly insisted on removing the intermediary RosUkrEnergo from the system of gas supply, something that has now been done. On the Ukrainian side, RosUkrEnergo is controlled by the businessman Dmitry Firtash, who, according to many media sources, is close to President Yushchenko.

At the end of last year, Timoshenko was prepared to fly to Moscow to sign agreements with the Putin-Medvedev government. Yushchenko, however, blocked her visit because he feared that success in Moscow might give Timoshenko significant advantage over him in the lead-up to the next presidential elections to be held in January of 2010.

Yushchenko was forced to reconcile himself to the agreements that Timoshenko signed in Moscow on January 19. However, he called them a "clear loss," finding support in the oppositional Party of Regions, which accused Timoshenko of betraying national interests.

In reply, Timoshenko threatened to name politicians and bureaucrats who are mired in corruption and who are advocating, according to her, an escalation of the natural gas conflict with Russia. On the initiative of her supporters, the Supreme Rada demanded that the president immediately fire the head of the National Bank on suspicion of machinations in the currency market.

As the *Independent Gazette* wrote on January 26, "Yulia Timoshenko has recently begun a tough offensive against the president on many fronts."

The political tensions in Ukraine are exacerbated by the difficulties the country is encountering due to the world financial crisis. Prices for industrial products on the world market have fallen sharply, in some instances by a factor of nearly two. Because of this, many of Ukraine's enterprises are on the verge of closure or partial shutdown.

In the course of 2008, the leading Ukrainian stock exchange index fell by 85 percent. From September through December of last year the dollar doubled in relation to the national currency—from five to almost ten hryvni, and currently is equal to about eight hryvni. The budget lacks sufficient funds to support social benefits for the population at previous levels.

To put it bluntly, Ukraine has nothing with which to pay for Russian gas, especially at prices that are close to European levels.

According to calculations of the Russian weekly *Smart Money*, given an approximate price of $250 for 1,000 cubic meters, the Ukrainian "yearly spending on natural gas will reach $13.7 billion, which exceeds a third of the revenues of the country's budget for 2009 ($31 billion)."

In the words of the senior strategist for developing markets at RBC Capital Markets, Nigel Rendell, "In Ukraine there are a host of negative factors... there is no certainty that IMF aid [of about $16 billion] will save the country from default."

In turn, the direct losses for Russia's Gazprom due to the halting of natural gas through Ukrainian territory are estimated to be $1.5 billion to $2 billion. In a recent interview on the German television station ARD, Russian Prime Minister Putin declared that Gazprom had been forced to halt more than 100 wells—"of course, without the danger of technological consequences," he added.

The main motive behind Moscow's readiness to increase tension is a desire to achieve maximum profit from the export of energy resources, as well as to use economic levers to guarantee more advantageous geopolitical positions. When it comes to Ukraine, the point is to neutralize the consequences of the "Orange Revolution" and shift Ukrainian policy in a more pro-Russian direction.

The Kremlin's line, which is based on the conception of "energy power" developed by Putin, can be summarized as: "In gas we trust."

Gazprom accounts for more than 10 percent of Russia's gross domestic product (GDP), serving as the main channel for the export of Russia's natural gas and guaranteeing about one third of European demand gas. In Central and Eastern Europe, Russian gas covers about 60 percent of demand, and in Poland, Latvia, Lithuania and Finland, dependence on Russian gas approaches 100 percent.

Moscow has long been nurturing plans to place under its control the gas distribution system of Ukraine, which includes 37,500 kilometers of gas pipelines, 71 compression stations and 13 underground gas reservoirs, either by direct ownership or in the form of rent. Proposals to create a joint cartel with the participation of Ukraine, Russia and Germany were at one time actively supported by Germany's then-chancellor, Gerhard Schröder, but they were not realized because of the pro-American character of the "Orange Revolution."

Now this idea has come back to life, although in a somewhat different form. An example is the article by Andrew Wilson in the *Wall Street Journal Europe* on January 29, in which the author writes in favor of creating a three-sided consortium comprising the EU, Ukraine and Russia. Ukraine, in his opinion, must retain ownership of its share of the gas pipelines, but enter into a long-term lease with the new consortium. The latter must act on the basis of an international pact that would strengthen the norms of transparency and the mechanisms of resolving disputes, as well as guarantee the stability of supply.

Wilson sees the organization of a three-party consortium, which clearly strengthens Europe's position, as a pledge to "avoid the cancer of natural gas corruption" in Ukraine. Besides, he writes, such a scheme would allow for the "depoliticization" of Ukrainian pipelines and, in time, lead to "changes in all levels of the Russian system."

Gazprom has already gained preferences in Ukraine in the form of broadened access to the end user. According to an agreement with Naftogaz, this offspring of the Russian monopoly Gazprom Ukraina must receive up to 25 percent of the Ukrainian market.

Control over the gas transport system was the basis for regulating relations between Russia and Armenia and Belarus. In both countries, Gazprom became the owner or shareholder of gas pipeline networks or hydroelectric stations. As a result, Armenia buys Russian gas for $110 per thousand cubic meters, and Belarus, for $128.

The cutoff of Russian gas to Europe led to difficulties for a number of countries. Slovakia announced it was ready to reactivate one of the reactors at the atomic energy station Yaslovsk-Bogunits, but then abandoned the idea. Bulgaria demanded compensation from Russia for halting supply in the sum of approximately €250 million, and the Public Gas Corporation of Greece (DEPA) demanded €1 billion.

At the same time, discussion has begun over alternative sources of energy supply to Europe. Primarily, this means the Nabucco project, which proposes the transport of gas from Central Asia and the Caspian region by circumventing Russia.

Until now this project has not developed due to inadequate guarantees of its gas supplies and the complex geopolitical situation in the region. The gas pipeline must cross the territory of Turkey inhabited by the Kurds, who are fighting for national independence. During the war between Russia and Georgia in August 2008, it was announced that the Kurds had blown up the Baku-Dzheikhan pipeline, which interrupted supplies of oil for several days.

Turkey has its own geopolitical interests. Having traditionally close military ties to NATO and the US, Turkey wants to become a member of the EU, which was denied not long ago. "If you create a situation where Turkey is sitting on gas transit, then I don't see how this differs from Ukraine as far as Europe is concerned," says Andrew Neff, energy analyst with HIS Global Insight.

The problems connected with Nabucco were at the center of a conference held on January 27 in Budapest. Participants included representatives of Austria, Romania, Bulgaria, Hungary, Turkey and Germany; potential suppliers Azerbaijan, Kazakhstan and Turkmenistan; and Georgia as a transit country. Speakers at the conference included Mirek Topolánek, prime minister of the Czech Republic (which is chairing the EU); US Deputy Assistant Secretary of State Matthew Bryza; and president of the European Bank for Reconstruction and Development (EBRD), Thomas Mirow.

On the eve of the summit, Topolánek complained that the major member states of the EU, such as Germany, France, Great Britain and Italy, were not showing the necessary interest in Nabucco since they have their own means of securing natural gas. Meanwhile, the pipeline projects South Stream and North Stream, which are being built to obtain natural gas for Europe from Russia, represent a threat to Nabucco: the majority of the country-participants in Nabucco are simultaneously engaged in the Gazprom projects.

At the conference, Topolánek and Hungarian Prime Minister Ferenc Gyurcsány said that the Nabucco project, particularly in light of the recent gas crisis, is not purely commercial and that it must be seen as a political initiative capable of guaranteeing energy security and stability for Europe. Gyurcsány proposed at the initial stage to use the resources of the EU in order to "remove the risks which private investors will not take on themselves."

In response, Philippe Maystadt, president of the European Investment Bank (EIB), declared that the "bank will gladly support any country that is interested in Nabucco, however it is still early to say what the final response will be." He said the EIB would assume 25 percent of the €200-300 million in costs for the first stage (the value of the entire project is placed at €7.9 billion), but only after the completion of its technical-economic foundation and, at a minimum, the conclusion of an inter-governmental agreement.

Mirow, president of the EBRD, added: "We want to see contracts for gas supplies, guarantees on investment, and technical parameters." Besides this, Mirow stated, there must be a study of the possible impact on the ecology and of public opinion in the regions where the Nabucco pipeline will pass.

The difficulties of this project were briefly summarized by the Russian *Vedomosti* of January 28: "The main and practically unresolved problem of the Nabucco project is the shortage of gas; Azerbaijan and Turkmenistan have insufficient capacity, since they can guarantee no more than 3 billion cubic meters of gas per year, yet the launch of the project requires no less than 15 billion... Iran could supply the missing supply of gas, but US sanctions impede this. The Europeans feel that one more obstacle is the position of Turkey, which wants to receive for its own needs 15 percent of the calculated 30 billion annual volume of gas moved along the pipeline... The appeal of participants in the project to the EU for resources necessary to launch the project contradicts today's EU policy concerning competition, therefore the EU cannot support it..."

Regardless of how events develop, the essential dependence of Europe on the supply provided by Russian energy systems will continue. This adds greater acuteness to the gas conflict between Russia and Ukraine, which is far from resolved. The readiness of today's ruling elites to make entire countries hostages of their drive for profit and geopolitical influence inevitably will provoke the outbreak of new conflicts. The main burden of these conflicts will fall on tens and hundreds of millions of ordinary people.

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