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The battle for Ukraine's energy allegiance

Natalia Shapovalova

›› As the main route for Russian gas into Europe, Ukraine is vital to both European and Russian energy security. The European Union (EU) seeks to secure gas supplies through Ukraine by integrating its eastern neighbour into the European energy market.Russia is seeking to prevent EU-led reforms in Ukraine in order to secure stable gas export incomes and continue exerting power over its 'sphere of privileged interest'. Ukraine's elite does not wish for reform, but maintaining the status quo is no longer tenable either. Ukraine is increasingly forced to choose between the energy security guarantees of the EU and Russia.

HIGHLIGHTS

- Ukraine has taken some steps to reform its energy sector and integrate in the EU market, but reform goes too slowly; the country's energy sector remains ineffective, opaque and corrupt.
- Russia is looking to take over Ukraine's energy market: energy-inefficient Ukraine remains one of Gazprom's largest clients.
- Energy is in the centre of EU policy and aid to Ukraine, but the EU's inconsistent external energy policy weakens its leverage in the country.

UKRAINE MOVES CLOSER TO EUROPEAN ENERGY MARKETS...

Ukraine's new president Victor Yanukovych is often represented as pro-Russian in contrast with his predecessor Victor Yushchenko and ex-prime minister Yulia Tymoshenko. But in terms of relations with the EU, his government has managed to fulfil some promises that were not upheld by his ostensibly pro-European predecessors. In July, the Ukrainian parliament adopted a new law on the Ukrainian gas sector, aligning Ukraine with EU requirements and legislation.

Transposition of this law was necessary for Ukraine's membership of the European Energy Community. The latter initiative was established between the EU and a number of countries in south-eastern Europe in order to extend the EU's internal energy market beyond the bloc's borders. The law harmonises Ukrainian legislation with EU gas market regulations (Directive 2003/55/EC concerning common rules for the internal market in natural gas and Regulation 1775/2005 on conditions for access to the natural gas transmission networks) and enables the creation of a more competitive gas market. The new law envisages unbundling of gas exploration, transportation and supply, and guarantees equal access of operators to gas networks. It is also set to strengthen independence of the national regulatory body in order to eliminate political influence on the energy market.

The adoption of this law means that Ukraine will become a member of the European Energy Community in the next six months to a year, according to the EU energy commissioner. As part of its membership obligations, by 2018 Ukraine will have to implement other elements of EU energy policy which regulate the electricity market and energy-related environmental issues. Membership will ensure the competitiveness and transparency of Ukraine's energy market, investments in modernisation of infrastructure and new technologies and thus will reduce consumption and dependency on gas imports. For the EU it will mean stable gas supplies from Russia through Ukraine.

Despite this advance, the state has maintained its control over state-owned gas exploration companies. They will be forced to sell gas to a government company at a regulated price. This allows the state to manipulate household energy prices, which will further impede the development of the gas exploration market. Furthermore, the new law does not prevent foreign monopolies, such as Russian Gazprom, from operating in the Ukrainian market.

The new Ukrainian government has also fulfilled another requirement set by the EU and other international organisations such as the International Monetary Fund (IMF). From August 2010, gas prices for domestic consumers have increased by half, and a further hike is forecast for 2011. In a desperate bid to secure an IMF loan and reduce the budget deficit, the government dared to do what its predecessor did not. Yanukovych raised gas prices despite his April 2010 statement that an increase would not be necessary due to the 'discounted' gas price that came with the 25-year prolongation of the Russian Black Sea Fleet's stationing in the Crimea.

...BUT RENT-SEEKING REMAINS

It remains to be seen whether the law will be implemented as fully as it should be. Experts point to a risk of hidden monopolisation. Unbundling and independent regulation of the gas market may exist on paper only. This occurred previously with the national regulator, which was in practice highly dependent on the government, even though legislation envisages the opposite.

Analysts say revenues from the gas price hike are not slated to go towards government investment into energy saving and infrastructure modernisation. The Ukrainian state oil and gas monopoly Naftogaz is preparing to pay a gas debt worth 3 billion dollars – equivalent to 12.1 billion cubic meters, or 20 per cent of Ukraine's annual gas consumption – to RosUkrEnergo, a 'middleman' jointly owned by Gazprom and Ukrainian oligarch Dmyro Firtash. The latter was allegedly one of the main sponsors of Yanukovych's presidential campaign. RosUkrEnergo was established as an intermediary selling Russian and Central Asian gas to Ukraine back in 2004, when Yanukovych was prime minister and the current energy minister, Yurii Boyko, was a key player at Naftogaz. Experts say the company was founded to create extra revenue for its stakeholders, both within the Ukrainian and Russian ruling elites. RosUkrEnergo's already advantageous position in the Ukrainian market strengthened after the Ukraine-Russia 'gas war' of 2006. In 2009, Yulia Tymoshenko's government reached a deal with Gazprom to remove the company from Ukraine-Russia gas trade. As part of the agreement, the government gained possession of 11 billion cubic meters of its gas, located in Ukrainian gas storage. When the government in Kiev changed, RosUkrEnergo sued Naftogaz at the Arbitration Tribunal of the Stockholm Chamber of Commerce, winning the case.

Analysts believe that the government will now pay out, as it barely attempted to defend Ukraine's interests in the courtroom. Presumably, under pressure from Gazprom, any evidence pointing to a link between RosUkrEnergo and the Russian monopoly – or, more accurately, to the latter's control over the former – was discarded from the case, weakening Naftogaz's position. Moreover, a Ukrainian court approved the Stockholm court ruling, meaning that Ukrainian authorities are obliged to comply.

If the claimed gas is returned to RosUkrEnergo, Ukraine will have to purchase more from Russia. An energy advisor for the opposition estimated that Gazprom would earn over 1 billion dollars as owner of half of RosUkrEnergo. Moreover, Naftogaz's financial situation would decline still further.

RUSSIA: STALLING UKRAINE'S ENERGY MODERNISATION

The gas wars between Ukraine and Russia in 2006 and 2009 led to Russian energy giant Gazprom edging into Ukraine's domestic market. Responding to the new Ukrainian government's Russia-friendly policy, the Kremlin has changed its tactics from waging war to attempting a peaceful takeover. In April 2010, when the ink on the gas-for-fleet deal had barely dried, Russian prime minister Vladimir Putin offered Ukraine a Gazprom and Naftogaz merger nominally as a means to invest in the modernisation of Ukraine's gas transit system. Yanukovych rebutted the proposal with a joke that such a deal would be possible only if the two companies exchanged 50 per cent of their stocks – irrational given Gazprom's size.

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Instead, Ukraine suggested creating a tripartite EU-Ukraine-Russia consortium, an idea that was discussed in president Kuchma's time. The government indicated it was ready to implement a joint EU-Ukraine declaration signed by Yulia Tymoshenko in March 2009, in which Ukraine promised to reform the energy sector and the EU to participate in modernising Ukraine's gas transit system. The EU has not yet reacted to Yanukovych's consortium proposal.

Unlike the EU, Russia does not ask for liberalising reforms. On the contrary, Russia benefits from an opaque and uncompetitive gas market in Ukraine. However, despite the leanings of the government, Ukraine feels insecure about Russian energy policy. Having lost control of the pipelines, the Ukrainian government will have no bargaining power over establishing prices for imported gas, and will be deprived of this important source of rent. This explains why Yanukovych, despite his moves towards Russia's outstretched arms, has not been eager to accept Putin's proposal.

Yanukovych's soft 'no' has not prevented Russia from insisting on a merger between the Russian and Ukrainian energy sectors. The two countries have increased their cooperation vis-à-vis nuclear energy. Russia has offered Ukraine a 2 billion dollar credit to construct two additional reactors on the Soviet-built nuclear power plant, which will allow Russia to install its own technologies and supply uranium to Ukraine. The Ukrainian government is also considering Russian investment in the construction of a factory to produce nuclear fuel.

Russia will keep looking for other ways gradually to edge its way into the Ukrainian gas market. It may draw on its experiences in Belarus, where state energy assets were acquired in lieu of Belarusian debts to Gazprom. Even though a merger has been discounted, Ukraine and Russia have launched talks on a possible joint venture between Naftogaz and Gazprom, to which the latter promises to contribute a gas field with a volume of one trillion cubic metres.

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It is unclear exactly what kind of venture is under negotiation and what Ukraine's motivation is. Is its government serious about giving Russia access to its pipelines in exchange for admittance to Russian gas exploration? Or is it merely negotiating for a new intermediate company that will allow the Russian and Ukrainian elites to keep profiting from gas transit to Europe?

Ukraine's main fear is that its pipelines will become redundant once the North and South Streams start carrying Russian gas to European clients and bypassing Ukraine. The EU-driven Nabucco pipeline may also weaken Ukraine's transit leverage. Still, Ukraine is rather supportive of Nabucco, but openly opposed to the South Stream project that is pushed by Moscow. Tymoshenko's government even promoted the White Stream, an alternative route that would include Ukraine, but this project is long-since stalled. Although the EU supports Nabucco rather than South Stream, Russia has managed to secure initial backing from almost all EU member states which also support Nabucco. This situation is deeply troubling for the Ukrainian ruling elite.

Russia is interested in controlling transit routes to Europe, but even more interested in preserving its source of income from gas export. Europe's diversification plans are gradually becoming a more realistic threat to Russia. According to estimates, Ukraine also possesses approximately two trillion cubic metres of shale gas. However, the country needs foreign investment and technologies to explore these reserves and for this energy market reform is necessary. Meanwhile, energy-inefficient Ukraine remains one of the largest gas consumers in the world and one of Gazprom's largest clients. Russia is interested in maintaining Ukraine as a client, which means keeping Ukraine's energy sector old-fashioned and ineffective.

EU INCONSISTENCY

While Russia is aiming to take over Ukraine's energy sector to secure transit and consumption, EU policy towards Ukraine and eastern neighbour states is largely based on a market and institutions approach. This means that the EU aspires to extend its energy rules to Ukraine and make the Ukrainian energy market transparent and competitive.

In 2005, the EU and Ukraine signed a Memorandum of Understanding on energy cooperation. In 2007, the EU allocated 87 million Euros (including 83 million in direct budget support) to assist energy reform in Ukraine: this accounts for more than 60 per cent of total EU aid to Ukraine disbursed via the European Neighbourhood and Partnership Instrument. In 2008, another 70 million Euros were allocated for the same purpose. Additionally, in 2009 the European Commission pledged its assistance in the modernisation of Ukraine's gas transit system, subject to reform progress in the country's energy sector.

However, despite the new gas market law, Ukraine's energy sector remains ineffective, opaque and corrupt. So, why does EU policy bear no fruit in Ukraine? To some extent, the unwillingness of Ukraine's elite to reform is responsible. Regardless of the political party in power, rent-seeking prevails and energy is used as a domestic political weapon to secure electoral support. Energy resources lubricate the wheels of patronage. Successive governments see no rational or normative motivation for change.

But part of the responsibility also lies with the EU. Its stance towards Ukraine is weakened by the lack of a common EU position. After Putin announced his Naftogaz acquisition plan, the only official reaction from the EU came from the energy commissioner, who stated that a takeover of Ukraine's gas transit system would be a purely bilateral matter between Ukraine and Russia. This position contradicted the EU policy towards Ukraine. A Gazprom–Naftogaz merger would mean the end of any market liberalisation and rule-harmonisation plans by Ukraine. Ukraine would be unable to hold membership of the European Energy Community. There can be no illusions about this: Russia does not play the game by EU rules, instead using energy as a political weapon. The EU is trying to prevent state-run Gazprom from expanding its monopoly into European markets. The Ukrainian merger would only strengthen its monopoly position in gas transit to Europe.

The EU sends Ukraine misleading signals regarding its supply diversification policy. The EU declares that it wants to decrease its dependence on Russian gas; yet North Stream will only deepen that dependence. The EU energy commissioner says that there is no route more profitable and reliable than transit through Ukraine; yet Gazprom has secured the support of European companies for the South Stream project. The Ukrainian government advocates a tripartite gas transit consortium offer on the table; yet the EU continues its evasive, wait-and-see approach.

SOLUTIONS

Time is on Russia's side. Ukraine feels under increasing pressure: it is running out of money, and its pipelines are deteriorating while new routes that will bypass Ukraine are being built. The EU's wait-and-see approach is actually damaging its own energy security.

From an energy security perspective, the EU is interested in extending its rules into its neighbourhood. If Ukraine is integrated into the EU market, this will serve as an encouragement to Russia to modify its geopolitical approach. But if Ukraine is absorbed by Russia, EU dependence on Russia will only increase, depriving the EU of its soft power in the neighbourhood.

From a wider foreign policy perspective, in the case of a Russian takeover of Ukraine's energy sector, the EU's influence on Ukraine will weaken across the board. As energy integration with Russia will entail wider economic integration; Russian business-state interests will dictate Ukraine's policies and norms. There will be even fewer incentives for Ukraine to reform.

The struggle between rent and reform does not merely pertain to the energy sector. Gas has always been the largest source of rent for Ukraine's elite. The issue at stake is whether Ukraine will turn into a normal country governed democratically and developing towards a modern market economy, or will become part of Russia's petrostate, nourishing the bigger country's fading power.

What can the EU do about it? Due to the transformation potential of its accession policy, the EU could help Ukraine to become an independent and democratic actor, but it has chosen not to do so. While energy is a key policy area in EU-Ukraine relations, it suffers from the same problem as EU policy towards Ukraine in general: a lack of strategic end-goals and insufficient incentives to provide forward momentum.

In the short term, the EU should insist on implementation of the joint declaration on modernisation of the gas transit system. The tripartite EU-Ukraine-Russia consortium option is certainly worth considering. A common and clear stance on the EU pipeline policy is needed. Finally, the EU should promote energy reform in a more responsible way. Budget aid and loans will yield no results if they continue without strict conditionality and stringent monitoring of reform results. Formal legislative changes must be implemented in practice; the EU must not be hoodwinked by the mere adoption of drafts and concepts as is often the case. Public scrutiny of budget support should be part of the aid programme. The solution to this enormously important policy challenge of Ukraine's energy policy identity must be political in the broadest sense.

Natalia Shapovalova is researcher at FRIDE.

e-mail:fride@fride.org
www.fride.org