

# BULLETIN

No. 23 (356) • March 5, 2012 • © PISM

Editors: Marcin Zaborowski (Editor-in-Chief), Katarzyna Staniewska (Executive Editor),  
Jarosław Ćwiek-Karpowicz, Beata Górka-Winter, Artur Gradziuk, Beata Wojna

---

## Ukrainian–Russian Gas Negotiations: Consequences for the European Union

Igor Lyubashenko

*By using Ukraine's attempts to get a reduction in the price of Russian gas, Gazprom is trying to obtain a monopoly on the Ukrainian market. If Russia achieves this goal, it will hamper the liberalization process of the Ukrainian gas market in accordance with the European Union's energy policy. The EU should continue to support the reform of Ukraine's energy sector and make efforts to join the Ukrainian–Russian negotiations as a liaison.*

On 17 February 2011, the Russian ambassador to Ukraine, Mikhail Zurabov, announced his country's will to resume negotiations on the price of gas exported to Ukraine, which was interrupted at the end of 2011, thus indicating the possibility to renegotiate the agreement between Gazprom, the Russian concern, and the Ukrainian state energy company Naftogaz. The current contract was concluded on 19 January 2009 for a period of 10 years and appeared to be unfavourable for Ukraine. The contract price of the Russian gas is determined by a base price of \$450 per 1000 m<sup>3</sup>, and the market prices of various oil products. The contract contains a clause prohibiting re-exports and a "take-or-pay" principle, according to which Ukraine is obliged to receive at least 33 bcm of gas annually. The achievement of a lasting agreement seems unlikely. The only compromise Russia has offered so far in terms of gas prices (a discount for Ukraine on the contract gas price in exchange for an extension of a lease to station the Russian Black Sea Fleet in Crimea until 2042) was linked to political concessions from Ukraine and the maintenance of the current pricing policy.

**Russia's Position.** Russia's primary objective is to maintain the high price and the contracted amount of gas supplied to Naftogaz, which is Gazprom's largest wholesale customer. This will increase the predictability of revenues to the Russian economy, which is dependent on oil and gas exports. After the expiration of the existing agreement in 2019, these revenues can be maintained if Russia obtains a monopolistic position on gas transmission and distribution in the Ukrainian market. Therefore, Russia seeks to gain control over the Ukrainian gas transportation system in order to allow it to block Ukrainian projects to diversify that country's gas supply sources. That control also will provide Russia more flexibility in gas pricing on the Ukrainian internal market while eliminating Naftogaz as an intermediary in gas transit to the EU. The launch of North Stream in November 2011 and Turkey's permission to build South Stream in December 2011 are reasons Russia cites in arguments that the value of the assets of Naftogaz be reduced, thus facilitating the company's takeover by Gazprom.

By taking advantage of Ukraine's difficult situation, Russia is trying to increase Ukraine's economic dependence on Russia. Therefore, a proposal to switch payments for gas to rubles has also been presented. Because of a significant trade deficit with Russia, this could lead to a dangerous increase in Ukraine's debt to its Eastern partner. This in turn could become an additional mechanism to facilitate the takeover of Naftogaz's assets.

Russia also seeks to obtain control over the Ukrainian gas transportation system because of the political benefits of impeding Ukraine's integration with the EU in the energy field. As a member of the Energy Community (EC), Ukraine has committed itself to implement the EU's third energy package aimed at creating a free gas market by separating the production, transmission and distribution of gas and the construction of interconnections allowing the diversification of gas supply sources, but which is contrary to the interests of Russia.

**Ukraine's Position.** Natural gas is the main source of energy for Ukraine (40% of the energy balance). The primary objective of the Ukrainian authorities is to reduce the price of Russian gas, which covers two thirds of the country's demand. This would help the government of Ukraine run a balanced budgetary policy without a significant increase in gas prices for households. Gas prices on the domestic market are kept artificially low for both industry and households, which generates high costs to the state budget. By subsidizing the price of gas, Ukraine obtains a competitive advantage for its export-oriented chemical industry and metallurgy, which form the basis of the country's economy. The maintenance of low gas prices for households and municipal enterprises (about 50% of demand) is caused by the authorities' desire to maintain their popularity ahead of the parliamentary elections in autumn 2012. The rising Naftogaz debt caused by the subsidies of Russian gas is hampering dialogue with the International Monetary Fund, which is demanding the repair of public finances before the next tranche of a loan granted to Ukraine in 2008 is made.

In order to obtain a reduction in gas prices, the Ukrainian authorities have offered a number of concessions to Russia. In November 2011, the government agreed to the partial payment for Russian gas in rubles. It also decided that Naftogaz would receive a loan in rubles from Russian banks. Furthermore, representatives of the government announced in December 2012 that Ukraine may denounce the EC Treaty because of allegations that this institution has been insufficiently involved in solving the problems of the Ukrainian energy sector.

The interruption of the negotiations in December 2011 showed that the Ukrainian authorities expect Russia to resign from some of its demands. Giving up control of the gas transportation system is regarded as a serious threat to national security and the interests of various oligarchic groups. The government takes into account the possibility to extend negotiations at least until the end of 2012, as evidenced by the preparation of a budget with the assumption of the current price of Russian gas. In early 2012, the government announced an increase in its own gas production, which is currently around 20 bcm (about one-third of domestic consumption), and the re-intensification of work on building an LNG terminal in Odessa. The project was suspended because a positive outcome of the gas negotiations with Russia was expected.

**Conclusions and Recommendations for the EU.** The existing agreements between Gazprom and Naftogaz introduce transparency in gas relations between Ukraine and Russia and establish a clear procedure for resolving disputes. Therefore, the lack of compromise in the current negotiations between Ukraine and Russia probably will not become a reason for the suspension of Russian gas supplies to the EU. From the perspective of the EU and Poland, Ukraine's vulnerability to pressure from Russia on energy systems remains a crucial question. A monopolised and non-transparent gas market in Ukraine, which is in the interest of Russia, is contrary to the EU energy-policy goals of providing security through the liberalisation of the internal energy market and the extension of the appropriate regulatory framework to the neighbouring countries. Therefore, it is in the interest of the EU to keep Ukraine in the EC and support reforms of its energy market.

The Joint Declaration on the modernisation of Ukraine's gas transportation system of 23 March 2009, signed by the government of Ukraine, the European Commission, the European Investment Bank, the European Bank for Reconstruction and Development and the World Bank, should become the point of reference for the EU's actions towards Ukraine. Reaching a similar agreement for the entire gas sector seems to be necessary as is the development of mechanisms that support investments according to the principle of positive conditionality—gradual funding in exchange for implemented reforms. This should happen simultaneously with efforts to reduce corruption, develop the rule of law and increase public awareness of the importance of energy efficiency.

The EU should engage in the Ukrainian–Russian gas negotiations as a liaison in accordance with the declaration by the Commissioner for Energy Günther Oettinger of January 2012. It would help Ukraine avoid granting far-reaching political concessions that would be in conflict with its long-term interests and international obligations. Russian consent to the inclusion of the EU is unlikely. However, the EC treaty obliges the parties to refrain from actions that may affect the Community's objectives. One should consider the use of this clause as the basis for a Ukrainian application to obtain consultations from other EC participants in the negotiations with Russia.