



Peace and Energy in Ukraine... and Russia

By Jan H. Kalicki

Ukraine remains at a precipice between increased military escalation with Russia and eastern separatists, and concerted efforts – the latest in Minsk – to achieve a diplomatic settlement that recognizes its sovereignty and independence. If diplomacy prevails, President Poroshenko and his government will face a daunting agenda of defining a viable course between their preferred Western partners and their overbearing Eastern neighbor.

Energy will play a key role in the success of such an agenda, as indeed it does in the future prospects of Presidents Poroshenko and Putin themselves. Ukraine depends critically on energy supplies,

most of which still come from Russia. Its energy vulnerability to Russia is profound: Gazprom cut off Ukraine's gas supplies in 2006, 2009 and 2014 – with aftershocks felt in central Europe – and Kyiv owes nearly \$2 billion for Russia's more recent gas deliveries, which continue on a prepaid basis despite the conflict in the east.

In a cynical move, Gazprom has debited Kyiv for direct Russian gas supplies to the eastern separatists. This issue continues to fester as Gazprom receives further prepayments after warning earlier of "serious risks" to gas supplies both to Ukraine and to its European gas customers

through Ukraine – a threat it has tabled at least for the time being, as the EU reported on March 2 that the gas supply “winter package” remained intact until the end of the month.

While Russia has alternatives for oil shipments, it will continue to depend on Ukrainian transit for over 35 percent of its gas exports to Europe for at least five more years. That is because commercial costs and EU anti-monopoly barriers finally caused President Putin to drop the South Stream project he had pushed from Turkey to the Balkans as a way of circumventing Ukraine, which would have carried up to 63 billion cubic meters (bcm) per year to the European market – and to fall back on a North-South project with Turkey, dubbed “Turk Stream,” which would parallel the existing Blue Stream pipeline linking the two countries across the Black Sea and whose gas could ultimately reach some of the same markets envisaged by South Stream. (See natural gas pipeline map below.)

The International Monetary Fund is readying a \$40 billion rescue package – in a four-year extended fund facility – for Ukraine’s teetering economy, which easily could be undermined in the event of failure of energy supplies to Kyiv. Post-South Stream, Russian incentives will be to continue supplies provided that payments can be arranged. Ukrainian incentives will be to take advantage of the window between South and Turk Stream – or any other alternative pipeline arrangement – to increase its energy security against Russia over the longer term.

This window also makes it urgent for Europe and Ukraine to develop alternative gas supply arrangements. Pipeline flows can be reversed from countries in Central Europe, including

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Hungary, Poland and Slovakia, and additional pipeline connectors can be built. Longer term, liquefied natural gas (LNG) sourced from Algeria and the United States can also make a significant contribution. Altogether, the Western supply alternative can provide about three quarters of Ukraine’s supply requirements.

For the remaining quarter, another Eastern source beckons: vast Caspian natural gas reserves, beginning with Azerbaijan and potentially, over time, Turkmenistan. The Southern Caucasus Pipeline now under construction is focused on Turkey, both as a market and a commercial hub. A second SCP pipeline is also planned, and that could help to supply Ukraine. Furthermore, natural gas could be transported from Baku to Poti on Georgia’s coast, and relayed across the Black Sea to Odessa using compressed natural gas vessels.

Many in Russia suggest that it can enhance its leverage by shifting more of its natural gas supplies from west to east, taking advantage of the lucrative Asian markets and increasing pressure on European states inside and outside the EU, including Ukraine. With the exception of Sakhalin production, that is a much longer term proposition in the face of Russian infrastructure deficits and the substantial Western and Middle Eastern supplies already in place. The commercial hurdles facing Russia are illustrated by the vaunted long-term natural gas agreement between Moscow and Beijing, which still has not



Source: economist.com

resolved the critical issue of pricing.

Nevertheless, it remains likely that Ukraine will need Russian natural gas, if to a lesser extent, over the longer term. It can and should increase its own energy efficiency as part of planned structural reforms. But with substantially increased energy security achieved through alternative routes, both countries can move toward a more balanced commercial energy relationship than has prevailed in the past. In the framework of a diplomatic settlement, such a relationship could assure adequate energy supplies to all parts of Ukraine, including more autonomous Donetsk and Luhansk in the east. And it could help lessen the Russian cost of subsidizing their energy as well as broader

economic needs, at the same time as it must attend to Crimea and to its own economy – still dependent on oil and gas for more than half its exports and budget – which risks moving from recession to economic tailspin.

In the final analysis, it is a mistake to separate near-term military/diplomatic tradeoffs from the longer term need, which Russia and Ukraine share, for economic stability and energy security. Russia should make its energy peace now, or lose clients tomorrow. In close tandem with the EU, Ukraine can make the most of a window of opportunity between this harsh winter and the next. From a policy perspective, the takeaways are clear:

- Russia needs to adopt a market based energy strategy, both internally and externally, which is not undermined by neo-imperial ambitions;
- Ukraine needs to diversify rapidly its energy sources as well as reform its energy system, so as to reduce markedly its vulnerability to future Russian disruptions; and
- the European Union needs to intensify its policy coherence, not only forestalling monopoly behavior but promoting diversification of supplies in the energy space.

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