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The 2009 Gas Dispute: Implications for Ukraine, Russia and the EU

The new gas deal is a step forward in ending a period of “special” relations between Kyiv and Moscow when it comes to gas, writes ICPS Senior Economist Ildar Gazizullin. In an article for ISS Opinion, a publication of the EU Institute for Security Studies, the economist says that a more transparent gas import scheme in Ukraine and the convergence of import prices with those in the EU will definitely make rent-seeking activities less likely. However, Ukraine’s economy and its political leaders remain highly dependent on what terms Russia agrees for any gas supplies. Ukraine needs to start making its internal energy market and economy more resilient to possible Russian abuse of its market clout in the future

The Kyiv–Moscow gas dispute of 2008–2009 was the culmination of “special” relations regarding to gas that have persisted since the early 1990s. The dispute over the commercial terms of Russian gas transit and supply clearly had political overtones as well. Moscow is still interested in gaining control over the energy assets in post-soviet countries and political actors in Kyiv continue to view the energy sector as rent-seeking cash cow. Only this time, the dispute led to a prolonged disruption of gas supplies that simply discredited both countries as reliable EU energy partners.

A major step forward

At first sight, the new gas deal reached between Ukraine’s Naftogaz and Russia’s Gazprom is a major leap toward transparency and predictability. The price of imported gas will be set according to a defined formula and the gas price gap between Ukraine and the EU will practically disappear in 2009. All of that would significantly limit the rent-seeking opportunities for Russian and Ukrainian politicians. However, there are reasons to suspect the new transit deal is not the actual final solution.

First, political leaders in Ukraine have already made contradictory assessments of the agreement. Premier Tymoshenko, who is considered one of the authors of the deal, was severely criticized by her political rivals, especially President Yushchenko. The gas deal will clearly

become a major issue in the Presidential campaign coming up in 2009.

Second, as experience with past gas deals has shown, there are always important things that are kept below the waterline, so to speak. For example, the expected presence of Gazprom on the Ukrainian market, as some Ukrainian officials are saying, is not specified in those documents available for public scrutiny.

Finally, the potential for rent-seeking in the energy sector has not been completely ruled out. There is clearly discretion left in implementing the contract: the issue of who inherits the assets, liabilities and functions of RosUkrEnerg is just one example.

Another possible consequence to Ukraine of the new gas import scheme is that it will shift emphasis to the domestic energy sector. The Ukrainian Government is facing the challenging task of making and facilitating change in the ownership, market structure, and prices of domestic energy.

The timing of the transition to the formula approach is favorable for Ukraine, since world energy prices will likely rise again over the next few years, after the free-fall they have been in since August 2008. Nonetheless, the transition to higher prices will not be an easy one for the economy. 2009 will be one of the worst in terms of GDP contraction and unemployment growth because of Ukraine’s extreme openness and dependence on just a few energy-

intensive export commodities. Moreover, Ukraine is one of the few countries in the world not to see a fall in energy prices this year, which will contribute to higher inflation.

Problems below the surface

Politicians are facing increasingly difficult choices in helping affiliated businesses and voters to overcome the consequences of economic slowdown and higher gas prices. Still, higher domestic gas prices will be a greater challenge for residential consumers than for businesses.

Currently, all Ukrainians pay subsidized prices for gas and local utility services, as the Government was very reluctant to increase regulated rates in the face of an upcoming presidential election—the fifth general election in Ukraine in the past seven years. But with the country’s largest company in a state of severe financial distress, the practice of keeping residential gas rates low, at the expense of Naftogaz and commercial users, is no longer sustainable. The Government also has to meet the conditions of the latest IMF loan by increasing domestic gas prices. In short, the Government is facing the risk of non-payment and debt arrears, which would have the negative consequence of not meeting Gazprom’s payment deadlines.

The impact of higher gas prices on commercial users will also be significant, if selective. While all of Ukraine’s oligarchs are being battered by the crisis and will actively seek state support, only fertilizers producers and some steel companies will find it hard to remain competitive with higher gas costs. Energy-intensive companies enjoyed high profits in previous years that should help them through a short-term period of losses. Finally, the impact of the global slowdown in demand is much more significant for most energy-intensive businesses than any cost inflation resulting from the new gas contract.

What Ukraine should do

Ukraine's policy makers will have to focus on helping the domestic gas market and the economy adjust to the terms of the new gas agreement. This is the best response, given that the slow pace of reform in the energy sector has somewhat contributed to the inefficiency and ineffectiveness of the country's foreign policy.

Stimulating energy efficiency. The Government should pursue the policy of increasing energy efficiency rather than looking at changing the energy mix or transportation routes – not least because both are very expensive and long-term options. Ukraine consumes about 60 billion cubic meters (bcm) of gas annually: by comparison, the United Kingdom, the largest European consumer of gas, has a market size of about 100 bcm. Apart from increasing domestic gas prices—a much-needed incentive—the Government should also develop and implement regulations and run a public-awareness campaign. The last two measures are most relevant for non-commercial users of gas, who do not respond well to monetary incentives.

Securing investments in upstream oil and gas. Placing sound economic stimuli and regulations on the domestic gas market is much more effective than preventing investors from entering these sensitive sectors—they will enter anyway. Major internationals are interested in untapped oil and gas reserves that Ukraine does not have the money or technology to develop. Even assuming radical energy-saving in the future, the country will still remain one of the top five gas markets in Europe—a fact that Gazprom also cannot ignore. Hence, the Ukrainian Government must ensure a legislative environment for such things as revenue-sharing agreements and licensing that both attracts investors and prevents possible abuse from large energy companies.

Reforming the gas market. Pursuing gas market liberalization will better serve the needs of Ukrainian consumers and companies. It is now obvious that the strategy based on creating a national

champion in the sector (Naftogaz) has been ineffective. However, as the presence of large private foreign monopolies on the market increases, the Government will have less power to impose its rules of play. To ensure a positive outcome, it needs to significantly increase the capacity, independence and accountability of the national regulator.

Implications for Russia and the EU

The global recession and the fall of oil prices have taken Russia by surprise and definitely make its objective of post-soviet integration harder. Moscow could claim greater leverage over Kyiv at a time when Ukraine paid a price that half that in the EU. The expansionist Russian energy strategy, however, is far from complete in Ukraine: Moscow still has aspirations to control the country's gas transportation system and the gas market in general. Russia will keep trying hard to replicate its success in gaining control over gas distribution and supply in other Central European countries.

The EU will continue to be heavily dependent on both Russia and Ukraine in the next 5–10 years regardless of any efforts to change the energy mix or transportation routes. The Union will likely continue its current approach of changing the rules of the game rather than playing games with no rules at all. Right now, the EU is increasingly calling for the construction of new gas pipelines, helping European energy companies promote their interests in the Russian upstream oil and gas market, and taking stakes in the business of gas transit through Ukraine. As it seems from EU reaction, member states will continue to focus on raising energy efficiency and the share of renewables rather than on diversifying gas transit and supply routes.

Stick to Europeanization

EU-Ukraine relations will not change dramatically. The EU will neither offer Ukraine prospects of membership in order to "secure" the transit of fuels. Nor will it end negotiations on an Agreement on Association Agreement with Ukraine.

The EU will continue to be involved in Ukraine's energy sector through financial support and continuing negotiations on Ukraine's membership in the Energy Community.

The EU's positive influence on transforming the Ukrainian gas market should grow with the deep Free Trade Agreement. This should follow as much as possible the EU approach towards candidate countries: increasing capacity in policy-making and institution-building, as well as in adapting to EU sectoral regulations and standards. The EU should ensure that the legal convergence in the Ukrainian energy sector goes deep enough and is not overly dilatory. Still, transforming Ukrainian energy markets and institutions in accordance with EU standards will take a long time.

A possible change in Ukraine's political landscape in the coming years should not get in the way of Europeanizing its energy sector. Even parties that use pro-Russian rhetoric are interested in more economic integration with countries in the European Union. The opposite is also true: all political parties seek support from Moscow. As the 2009 gas deal indicates, Premier Tymoshenko could become the politician with whom the Kremlin is most willing to cooperate in the future.

Nevertheless, it is the European Union that proposes an energy market model that provides a system of checks and balances. One way to speed up the reform process is to consider launching investment projects to integrate the local gas and power networks that could be of interest to the Ukrainian government and businesses. These projects can best be implemented through the Energy Community, which sets ambitious goals for its members in regulatory, economic and network integration. ■

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