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Once Again, the Russia-Ukraine Battle over Gas about Much More than Economics

By Tammy Lynch

Here we go again.

On January 1, for the second time in three years, Russia turned off the gas to Ukraine. The move came despite Ukraine's full payment for all gas received in 2008 and despite Ukraine's requests to continue negotiating.

At its core, Russia's action demonstrates clearly that the country is prepared to use intimidation as much more than a last resort, while resorting to what appear to be very shallow pretexts as justification.

In a full-court, multi-lingual public relations campaign, Russia's Gazprom gas monopoly has listed a series of grievances that seemingly allowed it no choice, but to turn off the gas. These include an alleged failure to pay debts owed for gas, an attempt by Ukraine to demand Russia pay more for transiting Europe's gas through its territory and Ukraine's "apparent unwillingness to move towards fair market prices for gas supplies." (1)

These claims are similar to those made on 1 January 2006 when Gazprom turned off Ukraine's gas for the first time – particularly the claims about payment. The difference now is that these claims have much less basis in fact.

In 2006, Ukraine privately admitted owing a significant debt to Gazprom and requested a combination of debt forgiveness and a settling of the debt through

return of gas in storage. The country also stubbornly demanded an arbitrary gas price far below market value.

In 2008, Ukraine did accrue short-term debt for gas during the fall months, but settled most of that debt by early December, and the rest with a payment of \$1.55 billion several days before the end of 2008. The conflict this year concerns between \$500 million and \$650 million in late fees, penalties, and administrative fees that Gazprom suggests are owed. The figure has risen since the conflict began, even though no gas is being provided.

Ukraine disputes those fees and has begun the process of asking the Stockholm Board of Arbitration for a ruling. It is likely that the country will owe at least a portion of the fees, but the final figure is in dispute. Unlike accepted Western practice, Gazprom has chosen not to wait for an arbitrator's decision before acting on these disputed debts.

Furthermore, Ukraine's price negotiations this year are far from arbitrary and designed to move the country from an unsupportable below-market price to a clear market price by 1 January 2011.

Just three months ago, on 2 October 2008, Ukraine's Prime Minister Yulia Tymoshenko and Russia's Prime Minister Vladimir Putin signed a memorandum detailing the framework for gas negotiations and agreement. The two "confirmed their intention" to move gradually in a three-step process "over the next three years to market, economically-based ... prices for the importation of gas to Ukrainian consumers and the tariffs for gas transit across the territory of Ukraine."
(2)

Following the meeting, Tymoshenko announced that Ukraine would pay 50% of average market price in 2009, 75% in 2010 and 100% of market price in 2011. Neither Putin nor Gazprom disputed this account of their negotiations.

The question, of course, is – what is market price?

On 27 December, during negotiations with Ukraine's neighbor Belarus over that country's gas price, Gazprom spokesman Sergei Kupriyanov announced that the price would decrease by mid-2009 "for all European partners, for the Baltic states, and for Moldova" as gas prices caught up with oil prices. Moreover, Kupriyanov confirmed that Belarus' price would not increase as significantly as earlier predicted. (3)

In 2008, Belarus paid \$129 per 1000 cubic meters of gas, or \$50 less than Ukraine. That figure undermines statements by some who criticize Ukraine's agreement as enshrined in the October memorandum. Chris Weafer, chief strategist at Russia's UralSib, for example, yesterday supported Gazprom's decision to demand a major increase in Ukraine's gas price. Gazprom's international investors, he said, "did not sign up to be part of anybody's foreign aid program." (4)

Ukraine has responded to this type of criticism by offering to increase its gas price by approximately 40% to \$235 per 1000 cubic meters. However, in a joint letter to Gazprom, Yushchenko and Tymoshenko suggested that the transit fee paid to Ukraine for exclusive use of the country's pipelines (\$1.6 mcm/km) is not enough to allow adequate maintenance of the pipeline system. Ukraine charges that the fee is at least three times below the figure paid to Western European partners. Gazprom has not disputed this claim, but suggests that the transit price is a "separate contract" that is not being negotiated.

Ukraine has drawn a line in the sand, however. It wants some level of increase in transit fees in any agreement.

Ignoring this demand, Gazprom today suggested that Ukraine must pay \$418 per

1000 cubic meters, which it said represents full market price. Gazprom officials suggest that Ukraine's rejection of a Gazprom offer of \$250 per 1,000 cubic meters means that all previous agreements were nullified.

But what about that \$250 offer? Given Ukraine's counter-offer of \$235, it appears that Russia is refusing to provide gas over a difference of \$15 per 1000 cubic meters, a request to increase transit fees and a planned submission of late fees for an arbitrator's opinion. Are these insurmountable issues? Are we to understand that no compromise can result from two sides that appear so close?

Apparently so.

This action once again seems to indicate that, if negotiations don't proceed exactly as its leaders would like, Russia is prepared to respond with displays of power and intimidation instead of compromise. From the first Ukraine gas cut-off in 2006, to another gas shut-off in Moldova that same year, to arbitrary food embargoes of its neighbors' products, to the August invasion of Georgia, Russia is always prepared to show its might.

Russia has demonstrated a willingness to force a deal on its terms using both economic and military methods. And few countries have stood their ground. Those that have—like the tiny Republic of Georgia—usually have done so alone and have paid a price.

Of course, there are reasons why Russia is irritated with Ukraine. The country fell behind in its gas payments last fall and paid accounts for September through November late. Yushchenko has refused to extend Russia's lease of the Sevastopol naval base in Crimea and has pushed to secure a NATO membership action plan. Ukraine also has limited the use of the Russian language in films and begun enforcing laws that limit the number of hours of Russian language programming on television.

But what now? Unlike 2006, when Ukraine had little gas storage and seemed desperate for a return of the gas flow, in 2008, its leaders have hardened their position. Ukraine now says it has amassed enough gas in storage to last until April without gas deliveries. It is unclear, however, how much damage a protracted disagreement would cause to Ukraine's already fragile economy. Its production facilities rely on gas for power.

For its part, Russia has not said how long it can maintain a lower gas pressure in the pipeline. The shut off to Ukraine in 2006 lowered pipeline pressure so significantly that power distributors in Italy and France were forced to shut down their plants. So far this situation has not repeated itself.

But for each week Russia does not provide gas to Ukraine, Gazprom could lose up to \$200 million in payments. Within days it will become clear just how long Russia is willing to go without a gas contract, and just what it is willing to do to get one.

Source Notes:

(1) Statement by Gazprom, 1 Jan 08, <http://www.gazpromukrainefacts.com/>.

(2) "About the gas sphere," 2 Oct 08, memorandum signed in Moscow by Prime Ministers Vladimir Putin and Yulia Tymoshenko. In Russian. Copy available from the author. Also see "???? ?????????? ?????????? "????? ?????????," Ukrayinska Pravda, 3 Oct 08, in Ukrainian and Russian.

(3) "Gazprom: Gas price for Belarus in 2009 to be higher than in 2008, but lower than contract amount," Interfax, 27 Dec 08 as reproduced in Kyiv Post, 1750 GMT, 27 Dec 08.

(4) "Russia cuts off gas to Ukraine," Agence France Presse, 1 January 08 via Google News.

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