

The Ukraine crisis

Not solved yet

The resolution of the gas crisis between Russia and Ukraine remains fragile. Although ten-year agreements are now in place, it is far from clear that Ukraine will be capable of meeting the terms of the agreement. According to Professor Jonathan Stern, Head of Gas Research at the Oxford Institute for Energy Studies, the future is very worrying. 'It's not clear what will happen if the Ukrainians fail to pay.'

| by Alex Forbes

Europe has just been through arguably its worst-ever energy supply crisis. The context of the gas dispute between Russia and Ukraine goes back to the break-up of the Soviet Union – it's not something that's suddenly arisen. Why did it get so bad this time around?

After the break-up of the Soviet Union none of the countries involved had any money to pay each other for anything – let alone the magnitude of the gas supplies they were importing. So virtually every year in the 1990s the Russians cut off Ukraine – but the cuts didn't last long and, with one or two exceptions, had no repercussions for Europe. When Russia cut the Ukrainians off in January 2006, European supplies were affected, but it was only a 2-3 day crisis. The January 2009 event was completely unprecedented – out of all proportion to anything that happened previously.

Why was 2009 so bad? The general context was the impending economic crisis and the fall in oil and gas prices, which meant that Russia and Gazprom needed to collect all debts they could, and also ensure that prices for 2009 were as high as possible. The Ukrainian economy was already in crisis. There is also a political crisis, with the president and the prime minister unable to agree on anything. And there was a feeling that, with falling oil and gas prices, if Ukraine could spin this out it might well get a cheaper price for 2009.

What would you say the two sides were trying to achieve?

The Ukrainians took the view that because the Russians had cut them off, and therefore a contract had not been signed for supply for 2009, that invalidated the existing transit contract. And they knew that by not supplying Europe with gas the Russians would suffer not just reputationally but also

financially. The Russians took the view that if they cut off Ukraine, it would understand the seriousness of its actions and possibly not dare to jeopardise its relationship with Europe by endangering transit. In the event, both sides were wrong.

Although a ten-year agreement is now in place for supply and transit, the dispute is not entirely over, is it?. What's your view of the workability of that agreement?

The danger points come on the 7th day of every month when the Ukrainians have to pay for their previous month's gas. The contract says that if they fail to pay on time they will be required to pay a month in advance for the remainder of the contract. But, since the Ukrainians have virtually never managed to pay on time since the beginning of the post-Soviet era, it seems unrealistic to imagine they will now.

So there is a monthly potential trigger for further dispute?

That's right. Given the state of the Ukrainian economy, it's hard to see how they will be able to continue to pay for gas at what will be higher prices than in the past, when their economy was in much better shape. So the future doesn't look too great.

The Russia-Ukraine gas dispute is perceived as having become an annual event. Was enough done to prepare for it this time around?

Even though I and others foresaw that there would be a problem, in our wildest nightmares we did not imagine that all Russian supplies through Ukraine could be cut off for two weeks in the middle of winter. I'm still shocked by that outcome. Could people have prepared better? Well, right up until the last day of the year it seemed possible that both sides would



Gazprom Deputy Head Alexander Medvedev appears at a news conference in Moscow, January 2009. Photo: Filippov Alexei/ITAR-TASS Photo/Corbis

come to some kind of agreement. That the two sides were prepared to behave as they did, when they were so close to an agreement on December 31st, makes the future very worrying.

Is there a silver lining? Are the ten-year agreements for supply and transit an outcome that leaves the parties in a better position than they were before?

Let's be optimistic about this. The agreements they've signed look very much like European-type agreements. It will be much more difficult for anybody to say in future that Russia is discriminating against Ukraine on gas. There's still a bit of work to do on transit and storage, but the supply contract looks like a European pricing agreement. The problem is that just because a price is reasonable doesn't mean that Ukraine will be able to pay it. The state of the Ukrainian economy looks pretty disastrous. It's not clear what will happen if the Ukrainians fail to pay. It's also not clear whether there is going to be any European assistance for Ukraine.

What are the lessons of this crisis?

It's still too early to be clear. With hindsight my takeaway is that the Russian-Ukrainian gas relationship is inherently unstable and I'm not sure that Europe can rely on it for 20% of its gas supplies.

I see two possible ways forward. One is the much-discussed but never implemented, European consortium for owning and operating the Ukrainian transit network, which could provide finance, stability and monitoring of those flows. But the Ukrainians have always rejected that solution and I'm not

clear they're going to be more forthcoming in the future. The other is the also-much-discussed Russian bypass pipelines of Nord Stream and South Stream, where the Ukraine is simply bypassed. Both will take some years to put in place, both will cost billions and in the case of the bypass pipelines tens of billions of Euros. And they are not solutions which can be implemented in time for next winter.

So what should European governments be doing to prevent a recurrence of the suffering?

Ideally there would be common action under the leadership of either the European Union or the Energy Charter Secretariat. But it's not clear that Ukraine or Russia would accept that kind of leadership.

The most likely European reaction would be for the most important member states – Germany, Italy, France and possibly others – to come together and put severe pressure on Ukraine, possibly with offers of economic assistance, on the ownership of the transit infrastructure. I think Moscow would accept that. And I think there would be a chance the Ukrainian leadership would accept it. How quickly it could be done is not clear.

There are several planned pipelines that could bring more diversity to European supply, whether in sources or routes. You've mentioned Nord Stream and South Stream, and there is also Nabucco. Which do you see as most likely to come to fruition?

We're just publishing a new book, that we started working on way before the crisis, on the whole of the Russia and CIS gas market. What we've concluded by talking to all the resource-holders is there won't be enough gas from the Middle East and

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Caspian region for a 30 Bcm/year pipeline [i.e. for Nabucco, ed.] until the late 2010s at the very earliest and probably 2020. So any such pipeline is at least ten years away.

Up to about 2015, you have a maximum of 21 Bcm/year of exports from the Middle East and Caspian region, of which Turkey has already purchased 6 Bcm. There is an additional 13-15 Bcm/year from the second phase of Azerbaijan’s Shah Deniz development in the Caspian, of which some will stay in Turkey, some may be bought by Gazprom and the rest will be available for Europe. We don’t think that adds up to a 30 Bcm/year pipeline going from anywhere in this region to Europe until at least 2018 and probably 2020.

What prospects do you see for Iran becoming a supplier to Europe?

I’ve been following Iran for over 30 years and Iran exports less gas today than it did 30 years ago – it is a net gas importer. Its contract with Turkey has been a fairly disastrous commercial affair which has seen gas cut off in almost every winter since it started. The Iranians have massive internal requirements both for utility gas and for oil field reinjection. I’m extremely pessimistic about any kind of major gas export relationship between Iran and Europe. If it were to happen it would probably assist in minor diversification but it would be at least a decade and probably more like two decades before we could see Iran as a major source of gas.

What about Nord Stream and South Stream?

Nord Stream and South Stream are cast in a very different light as a result of this crisis. Its impact in south-east Europe was catastrophic. That puts more emphasis on South Stream than it does on Nord Stream. North-west Europe really saw very little impact. Slovakia had serious problems, and there were some problems in Hungary. But these were nothing like what happened in Bulgaria, Serbia, Croatia and the other Balkan countries. So the urgency is to build something like South Stream. But South Stream at the earliest couldn’t be with us until 2013, and it might take a year or two longer. Nord Stream

could be built faster but it is targeted at north-west Europe and the problem was in south-east Europe. That also leads you to speculate about creating more transportation capacity between the north and the south to get more gas down to south-east Europe in a crisis.

What about the potential role of LNG?

LNG is partly a short-term and partly a longer-term solution. But all the new terminals being built have very little potential to supply south-east Europe. The exception is the Rovigo terminal in Italy. But the new terminal planned in Poland and the Adria LNG terminal in Croatia haven’t started construction yet. The other thing to consider is that although we will have a surplus of LNG in the next 2-3 years, by the time these terminals are built we may be in a different LNG supply situation.

During the dispute you took the unusual step of publishing a humanitarian proposal. What prompted you to do that?

I was shocked at the attitude of all parties when the monitoring mission essentially failed to re-start deliveries; shocked that none of the parties stepped forward and said, ‘Well, look, we’re contractually in the right but we can’t allow people in south-east Europe to freeze. We just have to pay whatever money’s required and get this gas flowing again.’ That kind of initiative did not come forward until the European gas companies got together and eventually proposed their consortium, which in the end was not needed.

My feeling was that the message sent to south-eastern Europe was very bad. I felt it let down some of these new member states and accession countries enormously. People need to search their consciences and ask themselves ‘Why did it take another week until a group of European gas companies came up with a financial solution?’ – which, I believe, eventually led to the resolution of the crisis. That should have been up to governments and European authorities to do, not commercial companies.

'There won't be enough gas from the Middle East and Caspian region for the Nabucco pipeline until the late 2010s at the very earliest'

After the 2006 interruptions there was a lot of talk in Europe about the need to diversify supplies and transit routes, and perhaps to diversify into other energy sources. But not much happened. Do you think this crisis will shock the European Union into action?

A lot of people say nothing much happened, but that's not true. What happened was in the old member states. Italy, Spain, Germany and France learnt lessons from that crisis. What didn't happen was in south-eastern Europe, because – and this is a crucial point – the measures needed cost billions of Euros. Creating additional capacity, additional storage, making sure your LNG can get to where it is needed if pipeline supplies fail – for things to happen on this scale money has to be found. Countries in south-east Europe don't have that. In the immediate wake of the crisis President Barroso said 'We want to see rapid agreement in the Council ... for 5 billion Euros of unspent money to go on infrastructure spending, notably in energy'. It's the first time I've heard anyone talk about a figure that might be used, specifically targeted at this problem.

If it were up to you to decide how to spend that sum, what would be your priorities?

The absolute first priority is to create more north-south links for gas supplies, which would be relatively cheap – millions of Euros – and to address simple interconnection issues. For example, the Turks could not supply Bulgaria with any gas because the lines only flow the other way.

Russia's war with Georgia last summer contributed to worries that Europe is over-dependent on Russian gas. Are these concerns overdone?

There is nothing in this dispute or any other dispute which suggests that Russia is using gas as an economic and political weapon against Europe. In this dispute there is for the first time a question of a political element in Russian decision-making in relation to Ukraine. But that's the first time that I've seen this and it has to be argued very carefully. So, in my view, the Georgian conflict, despite its tragic consequences, had no



Professor Jonathan Stern, Head of Gas Research at the Oxford Institute for Energy Studies. Photo: Alex Forbes

impact on and no origins in any kind of Russian animosity or threat against Europe.

The fact is, though, that Europe is dependent for 20% of its gas supplies on the Ukrainian corridor. Therefore the Russian relationship with Ukraine, and events inside Ukraine, are key issues. If the Russian-Ukrainian relationship deteriorates, which I would argue was the principal cause of the 2009 crisis, that is a very, very great concern for Europe – and something that it can't ignore.

What could Europe do to improve its relations with Russia, given that it's going to be increasingly dependent on Russia for a large part of its energy supply?

There is an immediate question, as I've said, about the contractual situation and the physical situation – the contractual question being: can the Ukrainian corridor be somehow successfully contractualised? And, whether it can or not, is Europe going to welcome the transit avoidance pipelines in the Baltic and the Black Sea or will certain member states obstruct them?

What Europe has to do in a larger context is to examine whether its attitude towards Russia – which essentially has been 'we're disappointed that you don't share our political values and therefore we've got a problem signing any kind of major new agreement with you' – whether that attitude is going to be tenable and successful over the next five to ten years. Clearly there will voices which say 'we mustn't appease Russia, we must stand firm'. My view is slightly different – that Russia has certain national interests, as does Europe, and that we have to find a way of negotiating between Russian and European national interests.

Obviously the big picture question – potentially the most serious conflict – is the status of Ukraine and Georgia in relation to NATO and the European Union. We have to find some kind of meeting of minds on those big issues. But the narrow gas question is a contractual and ultimately physical pipeline issue. ■