ISS Opinion

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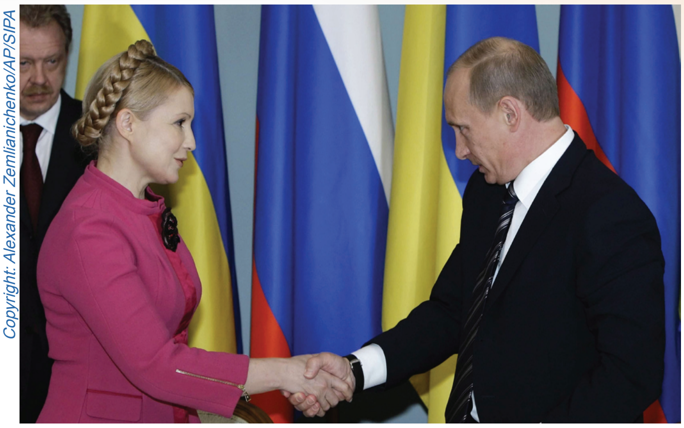
A UKRAINIAN PERSPECTIVE OF THE 2009 GAS DISPUTE

The new gas deal is a step forward in ending a period of 'special' energy relations between Kyiv and Moscow. A more transparent gas import scheme to Ukraine and the convergence of import prices with those in the EU definitely make rent-seeking activities less likely. However, the Ukrainian economy and political elites remain highly dependant on the terms of Russian gas supplies. Ukraine ought to start making its internal energy market and the economy more resilient to the possible Russian abuse of the market power in the future.



Russian Prime Minister Vladimir Putin and his Ukrainian counterpart Yulia Tymoshenko shake hands after signing a gas deal in Moscow, 19 January 2009.

Both political and commercial motives at play

The gas dispute between Kyiv and Moscow in 2008-9 became the climax of the 'special' energy relations between the two countries that have persisted since the early 1990s. The dispute over the commercial terms of the Russian gas transit and supply clearly had political motivation as well. Moscow is still interested in gaining control over the energy assets in the post-Soviet countries, and the political actors in Kyiv continue to view the energy sector as a source of rent-seeking. However, this time the dispute resulted in a prolonged disruption of gas supplies, which has further discredited both countries as reliable EU energy partners.

The comparatively low import gas prices that Ukraine enjoyed until recently were there for a number of reasons. First, Russia and Ukraine clearly recognised their mutual dependence, with Ukraine being one the largest consumers and transit countries of the Russian gas in the region. Therefore, the terms of supply but also of transit were favourable for both parties from the very beginning. The amount of rents that each country collected from the price distortions is complicated to assess, because of the consistently opaque nature of the gas contracts, which always involved intermediaries.

The immense rent-seeking potential in the gas sector had a significant impact on the political environment in Ukraine. Ukrainian parties are notorious for being closely connected with and financed by local businesses. (The 1998 elections provide anecdotal evidence: the Green party won seats in the parliament while being supported by heavy polluters of the environment.) Therefore, all parties in the parliament have a peculiar interest in the gas import scheme, since all fortunes in Ukraine were made in the energy sector or in the energy intensive industries.

From 2005 on the gas scheme could not be run as smoothly as before. Russia became more active in trying to gain control over the Ukrainian gas transport

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and supply infrastructure as world energy prices increased dramatically over the last few years. The political crisis in Ukraine that has persisted since the Orange Revolution has made it more difficult to distribute rents and negotiate new agreements. The fact it took so long to resolve the conflict this time can partially be blamed on the absence of effective cohabitation between the major political players, meaning that no important political decisions can be made.

New deal is a step forward, but future tensions possible

At first sight, the new gas deal reached between Ukrainian Naftogas and Russian Gazprom is a large leap toward transparency and predictability. The price of imported gas will be set according to a defined formula and the gas price gap in Ukraine and the EU will practically disappear already 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 final equilibrium solution. First, the political elites in Ukraine have already made contradictory assessments of the agreement. The Prime Minister, Yulia Tymoshenko, who is considered to be one of the authors of the deal, was severely criticised by her political rivals, notably President Viktor Yushchenko. The gas deal will clearly become a part of the presidential campaign with elections expected in 2009. Second, as the experience of the past gas deals implies, there are always important things that are kept under the water. For example, the expected presence of Gazprom on the Ukrainian market as mentioned by the Ukrainian officials is not yet specified in the publicly available documents.

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 inheriting the debts, assets and functions of RosUkrEnergo is but one example. Another possible consequence of the new gas import scheme to Ukraine 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 favourable for Ukraine since world energy prices will likely increase over the next 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 the growth in unemployment 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. Politicians are facing increasingly difficult choices in helping affiliated businesses and voters to overcome the consequences of economic slowdown and higher gas prices.

Higher domestic gas prices will be a greater challenge for residential consumers than for businesses. Currently all Ukrainians pay subsidised prices for gas and local utility services as the government was very reluctant to increase regulated rates (the presidential election will be the 5th election in Ukraine over the past six years). The practice of keeping low residential gas prices at the expense of Naftogas is, however, no longer sustainable since the largest company in the country is in a state of severe finan-

The Terms of the New Gas Contract

The contract (or rather contracts – on gas transit and supply) signed on 19 January between Ukraine and Russia explicitly deal with some of the concerns expressed by the stakeholders before and during the dispute:

1. The price of gas and transit will be derived from a formula that takes into account the world price of oil.

2. The physical parameters of the imported gas have been explicitly specified in the contract.

3. The payment deadlines have been made stricter and more binding for Naftogas.

4. It is a long-term contract for 10 years.

5. The transition period with price discounts for Ukraine is limited to 2009.

The terms of the contract are already being criticised inside and outside Ukraine as not corresponding to European practice and being commercially disastrous for the Ukrainian economy. The final assessment of the deal is, however, hard to make, because other Russian contracts with the EU member states are also not public.

Source: The contract was downloaded from the Ukrainska Pravda website (at www.pravda.com.ua) since it is viewed as confidential by the parties who signed it.

cial distress. The government also has to meet the conditions of the IMF loan by increasing domestic gas prices. Therefore, the government is facing the risk of non-payments and debt arrears, which would have the negative consequence of not meeting Gazprom payment deadlines.

The impact of the higher gas prices on commercial consumers will also be significant but selective. While all major oligarchs are battered by the crisis and will actively seek state aid, it will be only the producers of fertilisers and some steel companies that will find it hard to remain competitive paying higher gas prices. Energy-intensive companies enjoyed high profits in the previous years that should help them through the short-term period of losses. Finally, the contribution of the global slowdown in demand is much more important for most energy-intensive businesses than the cost inflation to be caused by the new gas contract.

Implications for Ukraine

Ukrainian 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 to an extent the slow pace of reform in the energy sector has contributed to the inefficiency and ineffectiveness of Ukrainian foreign policy.

Stimulating energy efficiency. The government should pursue the policy of increasing energy efficiency rather than the options of changing the energy mix or transportation routes – not least because both are very expensive and long-term options. Ukraine consumes about 60 billion cubic metres (bcm) of gas annually – for 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 necessary incentive – the government should also develop and implement regulations and a public-awareness campaign. The latter measures are most relevant for the non-commercial consumers of gas that do not respond well to monetary incentives.

Securing investments in the upstream oil and gas. Placing sound economic stimuli and regulations on the domestic gas market is much more effective than protecting investors from entering these sensitive sectors (since they will enter nonetheless). Major internationals are interested in the 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 there is the legislative environment (e.g, revenue sharing agreements, licensing) that both attracts investors and prevents possible abuse from the large energy companies.

Reforming the gas market. Pursuing gas market liberalisation 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 (Naftogas) 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 the game. Hence, the government should significantly increase the capacity of the national regulator, its independence and accountability, to ensure a positive outcome.

Implications for Russia and the EU

The global recession and the fall of oil prices have taken Russia by surprise and definitely make its task of post-Soviet integration harder. Moscow could boast a greater leverage on Kyiv at a time when Ukraine paid a price that was twice as low as that in the EU. The Russian expansionist energy strategy, however, is far from complete in Ukraine: Moscow has not abandoned its aspirations to control the Ukrainian gas transportation system and the gas market in general. Russia will keep trying hard to replicate its success of gaining control over gas distribution and supply in other Central European countries.

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

Stick to Europeanisation strategy

EU-Ukraine relations should not change dramatically – the EU will neither offer Ukraine a membership perspective in order to 'secure' the transit of energy, nor will it put halt on negotiations on an

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

The EU's positive influence on transforming the Ukrainian gas market should be increased within the framework of the deep Free Trade Agreement. This should follow as much as possible the EU approach towards the candidate countries of increasing capacity in policymaking and building institutions but also the adaptation of the 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 delayed. One should note, however, that transforming the Ukrainian energy markets and institutions in accordance with EU standards will take a long time.

The possible change of the political landscape in Ukraine in the coming years should not hinder the Europeanisation of its energy sector. Parties that have pro-Russian rhetoric are interested in more economic integration with the countries of the European Union. The opposite is also true – all political parties seek support from Moscow. As the 2009 gas deal indicates, Ms Tymoshenko could become the politician with whom the Kremlin is most willing to cooperate in the future. Nevertheless, it is the European Union that is proposing the energy market model providing the system of checks and balances.

One way to speed up the reform process is to consider launching investment projects on integrating the gas and power local networks that could be of interest to the Ukrainian government and businesses. These projects can best be implemented through the Energy Community that sets ambitious goals for its members in the areas of regulatory, economic and network integration.