



WHAT YANUKOVICH WOULD MEAN FOR GAS RELATIONS WITH RUSSIA AND EUROPE

The media frequently – and wrongly – describes the president-elect of Ukraine, Viktor Yanukovich, as “pro-Russian”¹. The label implies that in the geopolitical tussle for Ukraine between Russia and the West, the new leader favours the former. When asked, Yanukovich dismisses the argument as nonsense: like most Ukrainians, he thinks the country should look after its own interests, not Russia’s or the West’s. But in at least one important regard – in his gas strategy - Yanukovich plans to abandon policies favoured by Europe and put in place measures that would deepen Ukraine’s dependence on Russia.

During the presidential campaign, Yanukovich said that if elected he would “renegotiate” the contract under which Russia sells gas to Ukraine; he would also invite Russia to buy a stake in Ukraine’s gas transit system. His proposals would not only reverse a long-standing Ukrainian policy (requiring, among other things, a change in law) but they will almost certainly fail to achieve their stated objective: to lower the price at which Ukraine buys gas from Russia, and to deter Moscow from building gas pipelines to Western Europe bypassing Ukraine.

Why is gas so important to Yanukovich? Ukraine is one the most gas-thirsty countries on earth. It has done too little to reduce its consumption from the Soviet-era levels: to reform its old, energy-inefficient housing stock or modernise the gas-intensive steel mills and fertiliser plants. As a result, Ukraine consumes about \$900 million worth of gas a month in winter, when demand is at its highest. In per-capita terms, that is thrice the level of consumption of neighbouring Poland, another former communist country of comparable size.

Russia stopped giving Ukraine preferential rates for gas in the early 2000s, and price has been rising steadily since. The increasing outlays have had a ruinous effect on Ukraine’s finances – the country’s monopoly gas distributor, Naftogaz, has to be periodically rescued from insolvency by the Ukrainian government which, in turn, has resorted to borrowing money from the

¹ At the time of this writing, the election results remain unofficial pending a challenge by the defeated candidate, Yulia Tymoshenko.

International Monetary Fund to pay Naftogaz. The country is going broke trying to stay warm.

The staggering amounts of money involved in the gas business have also corrupted Ukraine's politics. In the early 1990s, top gas executives and the country's elected officials colluded to create a gas distribution cartel; circumstantial evidence suggests that the traders paid back a portion of their earnings in the form of illegal campaign contributions (the country's prime minister at the time was later sentenced in the US for fraud). The creation of a state gas monopoly, Naftogaz, in 1998 brought only limited improvement: the company did not even publish its accounts until the early 2000s. To this day, gas executives bankroll political parties and lobby the country's rulers against opening the trade to greater public scrutiny.

Ukraine has essentially two ways to reduce the financial burden that its unreformed gas sector imposes: by decreasing the amount of gas it consumes, or its price. Prime Minister Yulia Tymoshenko chose the former path. She agreed in 2009 to pay Russia "world" prices for gas, no different from those Moscow charges to Western Europe, and to raise domestic gas prices for Ukrainian customers. She also negotiated a package of loans from leading international financial institutions to mitigate the social impact of higher gas prices. And she got the European Commission to agree to pay for modernisation of the gas grid – this would cut down waste, thus reducing corruption (much of the gas declared "lost" to inefficiencies is in fact sold under the table). Hers was basically a shock therapy: she offered pain – higher gas prices – up front in exchange for reduced energy consumption – and thus lower bills – in the long run.

Tymoshenko, a defeated candidate in this year's presidential elections, never implemented the deal; she balked at raising gas prices so close to elections. She also used to run a gas wholesale business in the 1990s and is very much a part of the system, with all its imperfections. But she pointed the way to reform Ukraine's wasteful energy habits and reducing the country's dependence on Russian goodwill. Most former communist states of Central Europe have already implemented the sort of reforms she has outlined; some over a decade ago.

Yanukovich is proposing the exact opposite. He argues (correctly) that Ukraine cannot afford its high gas bill but instead of lowering consumption he wants Russia to lower gas price – that is what he means by "renegotiating" the

purchase contract. It is unclear what leads him to believe that he would succeed. It is true that Moscow used to give some of its neighbours favourable rates; these countries in return charged Moscow less to transport its gas to Western Europe. But Russia stopped this policy years ago and most of its neighbours, including Belarus, with which Russia is ostensibly allied in a federation, are paying or will soon pay world prices. In the unlikely event that Russia agreed to give Ukraine a lower price, Moscow would try to extract political concessions from Ukraine – like a guarantee that the country never hosts Western military exercises or bases. This may suit Yanukovich in the short run – he is sceptical about Ukraine joining NATO – but even he may want to avoid giving Moscow a tool for limiting Ukraine's future foreign policy options.

The president-elect also invited Russia to buy a part of the Ukrainian gas transit system. In doing so Yanukovich hopes to deter Moscow from building new gas pipelines bypassing Ukraine, Nordstream and Southstream, because these would deprive Ukraine of the lucrative income it earns from transit fees. But here, too, Yanukovich's proposals will make little difference. Southstream will probably never be built anyway; the demand for gas in Europe has dropped in recent years, as has the supply from Russia, which has trouble developing new sources of gas. In contrast, plans for the Nordstream pipeline have advanced too far to be stopped, which means that the pipelines transporting Russian gas through Ukraine will soon have a new competitor. When Nordstream starts carrying some of the gas currently going through Ukraine in 2011-2012, the country's income from transit will drop, as will Ukraine's importance to Russia's gas exports. This, in turn, will make Moscow even less likely to agree to sell gas to Ukraine at discounted prices.

The president-elect may yet reconsider his gas proposals; Ukraine's recent history is full of broken election promises. Yanukovich may also be thwarted by the country's parliament, which in 1995 passed a law prohibiting sales of energy infrastructure to foreigners. If Yanukovich goes ahead anyway (he could seek to have the law overturned), he would merely prolong Ukraine's dangerous dependence on cheap gas. Ironically, Ukraine produces much gas domestically and, experts say, with proper reforms it could become fully self-sufficient. That is what the European Union has been telling Ukraine for years; it has also offered financial help with the necessary reforms. Ultimately, Ukraine's interests would

be best served if Yanukovich tackled the country's gas-guzzling habits instead of seeking a better price from Russia.

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