

CRITICAL QUESTIONS

The European Gas Crisis

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Russia and Ukraine are locked in a bitter dispute over natural gas prices, payments, and transit fees. Russia stopped shipments intended for Ukraine on January 1 while continuing to supply gas intended for its European customers. It did so claiming that Ukraine had not paid \$600 million in penalties on late payments and had rejected the pricing terms of a new 2009 supply contract offered by Russia. Russia also accuses Ukraine of siphoning gas destined for Europe.

More than 80 percent of Russian gas supplies to Europe flow through Ukrainian pipelines. While Europe imports about a quarter of its natural gas from Russia, some countries, especially new EU member states, are almost completely dependent on Russian supply. As of January 6, several countries, including Austria, Romania, Bulgaria, Poland, Turkey, Italy, Germany, Slovakia, and the Czech Republic, the current seat of the EU presidency, reported drops in pipeline pressure resulting in reduced gas throughput. This comes during a period of near-zero temperatures across much of the Continent, raising concerns about the adequacy of European gas storage and alternative supply to meet the drop in Russian supply. Prior to the cutoff, Ukrainian officials stated that it had adequate natural gas in reserve to meet several months of domestic demand.

Q1: What has changed since 2006, when Russia also cut off gas supplies to Ukraine?

A1: The fundamentals of the situation have not changed much over the past three years. Conflict arises almost every winter when the annual contract expires and there is a renegotiation of prices or transit fees and outstanding balances are due. December 2008 found Ukraine reportedly \$2 billion in arrears, which put them in a significantly compromised position for contract negotiations. It is important to understand that this situation has been going on since 1992. While there was tremendous international attention in 2006 after Ukraine's Orange Revolution, this and other similar disputes with political and economic consequences have taken place between Russia and Ukraine ever since the breakup of the Soviet Union.

Q2: What is Europe's role in resolving the conflict between Ukraine and Russia?

A2: While the 2006 Russian gas cutoff brought attention to the role of energy as a vital security component, the European Union has been slow to implement the extensive and often politically challenging policy changes needed to create a cohesive and integrated energy market. The Orange Revolution presented an excellent opportunity to work with a newly empowered Ukrainian government to reform its gas sector, including transit, which is so vital to Europe's own energy security. However, this opportunity was squandered by both Ukraine and its Western friends.

There was much talk about new pipeline routes, such as Nordstream, Nabucco, and South Stream, but often these long-term projects are distractions from facing near-term energy realities. There are several actions that Europe can take to strengthen its immediate energy security. These include reducing the role of the monopolies and "national champions" that interfere with the actions of free markets and integrating the new members of the European Union that are the most reliant on Russia further into the Europe-wide energy infrastructure. Increasing market flexibility and building stronger interconnections and system redundancy can bolster European capacity to withstand supply shocks. Furthermore, the European Union should continue to support efforts for increasing efficiency, reducing consumption growth patterns, and promoting investment in alternative energy sources that can be sourced domestically and that have a lower carbon footprint.

Q3: What is the foreseeable resolution?

A3: Ultimately, both Russia and Ukraine have to protect their reputations as supply and transit partners to Europe, respectively. While each is pointing the blame at the other, they both realize the need to return to the negotiation table, as soon as January 8, to work for a resolution. The most immediate points to be resolved are the issues of gas price, transit fee, volumes, and penalty fines. However, any solution that is worked out will likely be a short-term fix as in the past.

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Until the Ukrainian leadership demonstrates the political will to reform, this is unlikely to be the last such dispute. Domestic reforms within Ukraine must include a pricing system to reflect the true economic value of gas (i.e., higher prices that would stimulate efficiency gains and increase domestic production for which there is strong geologic potential). The supply/transit relationship with Russia must be regularized according to international standards, including long-term contracts and transparent business practices. While this is in the best interest of both Russia and Ukraine, the question remains whether they are able to make the necessary changes to address fundamental problems.

Q4: What impact does the current Russia-Ukraine gas crisis have on international energy prices, particularly for oil?

A4: With the concurrent fighting in Gaza, it is difficult to gauge the degree to which oil markets are impacted by a larger Middle East crisis or the temporary European gas crisis. To the extent that the Russian gas cutoff has driven up spot prices for gas oil and fuel oil, it does also affect the physical market for crude oil in Europe, but its effects are likely to be short term and will dissipate after winter.

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