Analysis

Intermediaries and the Ukrainian Domestic Dimension of the Gas Conflict

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Abstract

On January 1, 2009, Russia suspended gas supplies to Ukraine, while continuing transit supplies to Europe. On January 7, all supplies to or through Ukraine were suspended. Complex negotiations brokered by the EU followed, leading to a monitoring mechanism intended to assure transit shipments would reach the EU despite the Russian-Ukrainian dispute. By January 19, despite the agreement, gas still failed to flow. This article looks into the causes of the January 2009 gas trade conflict between Ukraine and Russia and especially considers the role of intermediaries as well as Ukraine's complicated domestic situation.

Corruption in the Ukrainian Energy Sector as a Key Problem

The longstanding divisions of the political and economic landscape in Ukraine are an essential source of the recurring frictions in Russian-Ukrainian energy relations. In fact, energy is a prime example of Ukraine's difficulty in delimiting a distinct "Ukrainian" national interest, separate from Russia's. This breakdown is related to the elites' failure to fully comprehend Ukraine's situation of energy dependency until well into the mid-2000s, and to the structure of interests created by significant possibilities for corruption and rent-seeking in the area.

Especially during Leonid Kuchma's presidency (1994-2005), energy market transactions offered rich profit-making opportunity for those with the right connections. The rent-seeking opportunities were related to the manipulation of prices through barter trade; re-export of low-cost Russian oil and gas; the system of selective payments for gas from the state budget to private (but not public) companies; the profits accrued through the selective allocation of the most lucrative gas distribution contracts; the transfer of liability for non-payments to the state, and the de-facto joint "theft" of Gazprom's gas from Ukrainian pipelines.

Common to all these areas of potential rent-seeking was that profits were mostly made not at the expense of Gazprom or the Russian state, but the Ukrainian state budget and the Ukrainian people. Energy corruption severely hindered Ukraine's ability to agree on and implement a proactive energy policy, exactly at a time when Russia was becoming more proactive in this area. While the Ukrainian state was bleeding from inside as a result of such corruption, official gas prices paid by Ukraine for imports from Russia remained relatively low and largely stable: until 2005, Ukraine largely bartered transit services for gas supplies from Russia (which did not prevent significant debt problems from arising regularly, however).

Despite Viktor Yushchenko's campaign against the legacy of the Kuchma-era corruption, under his leadership the energy business continued to be a prime area of rent-seeking, corruption and competition between "clans." In fact, Yulia Tymoshenko's dismissal as prime minister in September 2005 is believed to have been triggered by her team's interference with the energy rent-seeking activities attributed to the Yushchenko entourage.

The Russia-Ukrainian 2006 Agreements and their Implications

An additional low point in Russian-Ukrainian energy relations came in the form of the January 4, 2006, agreements with Russia that brought to an end the three-day stoppage of gas supplies by Gazprom that sent shivers throughout Europe. It is essential to understand the content and implications of this agreement in order to grasp which issues were at stake in the 2008–09 negotiations.

After 2006, the Russia-Ukrainian energy business did not become more transparent. One reason was the strengthening of intermediary companies. Although intermediaries have long played a role in the Ukrainian-Central Asian gas trade, their role changed significantly after the January 4, 2006, agreements. If in the 1990s and early 2000s intermediary companies (such as ITERA and Eural Trans Gas) were paid large sums to organize the transport of Central Asian gas to Ukraine, under the new agreements of 2006, the company RosUkrEnergo, created in 2004 as a Swiss-registered joint venture between Gazprom and Austria's Centragas, became not just the transporter, but also the operator of all Ukrainian gas imports from Central Asia and Russia, giving the company much more power in the relationship.

On the Ukrainian domestic gas distribution market, the January 2006 agreements led to the creation of a new intermediary, UkrGazEnergo. UkrGazEnergo was created in February 2006 as a joint venture and given the right to distribute gas directly to industrial users in Ukraine, thus taking away from Naftogaz the financially strongest domestic consumers. As a result, UkrGazEnergo retained the profits, while Naftogaz not only lost its main source of profits, but continued to be contractually obliged to supply district heating companies and residential users, often unable to pay, bringing the company dangerously close to bankruptcy.

Apart from the enhanced power of intermediaries, the new agreement was detrimental to Ukrainian interests because, while it was agreed that gas prices would be revised yearly, Ukraine was locked until 2010 into accepting low transit fees (lower than those typically paid within the EU, but higher than the fees Belarus received). Also, the 2006 agreements further reduced Ukraine's ability to truly diversify its gas supplies, as they remained contractually tied to a single supplier (RosUkrEnergo) which in turn was tied to Russia, regardless of whether the imported gas actually came from Russia, Central Asia, or both.

Thus, when the two sides began negotiations in 2008 over the new prices and trade conditions, it was largely the legacy of the 2006 agreements that prevented finding a deal that would suit all parties involved.

The 2008 Negotiations and the Role of Intermediaries

Energy relations between Ukraine and Russia already saw serious strains in late February 2008, but were brought back to normal after Tymoshenko's March 12, 2008, negotiations in Moscow. Essentially, it was agreed that intermediaries would be removed: UkrGazEnergo (effective from March 1, 2008) and RosUkrEnergo (effective "some months later"). The Russian side agreed, but in return demanded that prices would increase (an additional 1.4 bcm of Russian gas was acknowledged as debt) and, as a replacement for UkrGazEnergo, Gazprom was promised the right to sell at least 7.5 bcm of gas directly to Ukrainian industrial users.

Despite some uncertainly about these agreements (they were called into question by President Yushchenko, and partially superseded by a new set of agreements signed by him on March 19), energy relations with Russia appeared to be going relatively smoothly in the following months. Discussions on RosUkrEnergo subsided, with the public assuming the company would cease its role as an intermediary at the end of 2008. Yet in early April 2008, it became known that RosUkrEnergo would remain the intermediary.

A new Tymoshenko-Putin meeting in early October brought the renewed hope that Ukraine would start buying gas directly from Gazprom, and that prices would gradually transition to market levels. Such agreements of principle were expected to be firmed up during Naftogaz head Oleg Dubina's expected visit to Moscow on November 11. Yet, due to circumstances which remain unknown, the result of the visit brought exactly the opposite: no agreement, and a hardening of Gazprom's position vis-à-vis Naftogaz, to which it demanded the pay-back of an even higher debt than previously discussed ($2.4 bn, while Naftogaz recognized only $1.3 billion to RosUkrEnergo). As an alternative to immediate payment, Gazprom proposed to Ukraine either to pay the debt in the form of transit services in 2009 ($2.4 bn is equal to 14 months' worth of transit services), or maintain the current scheme involving RosUkrEnergo; Ukraine rejected both options. After that, the situation started to escalate quickly.

This brief overview of events in 2008 tells us that the gas negotiations with Russia had only secondarily to do with prices, and much more with the profitable role of intermediary suppliers. It is sufficient to point out that RosUkrEnergo's profits from the re-export of Russian gas were estimated to be $2.25 bn in 2006, and approximately $2.9bn in 2007.

Even lacking "insider" information, it is possible to conclude that "someone" did not want the agreements to be fulfilled. According to Prime Minister Yulia Tymoshenko, the main culprit was RosUkrEnergo and its associates in Ukraine, in particular the "Party of Regions" members Yurii Boiko, Dmitro Firtash and Serhii Levochkin. According to Boiko, however, the main problem was an intermediary company associated with Tymoshenko (see *Radio Svoboda*, Ukrainian Service, January 13, 2009). Although we lack sufficient evidence to support either Tymoshenko's or Boiko's versions, the ability of such actors to hold Ukraine's energy policy hostage to their rent-seeking schemes is a factor seriously hindering the resolution of the conflict.

The Yushchenko-Tymoshenko Quarrel as a Further Obstacle

Although at the time of the crisis itself Yushenko and Tymoshenko came out with a joint declaration and a common position on the issue and sought not to undermine each other's credibility in public, the longstanding and deep conflict between Yuschenko and Tymoshenko and lack of clearly divided spheres of competence between president and prime minister undoubtedly contributed to the crisis. Throughout 2008, lack of clarity as to who was in charge of negotiations with Russia complicated the situation, and it was hardly surprising that Moscow would not take a decision on gas trade modalities for 2009 until it became clear who the interlocutor would be in Kyiv.

Even more problematic was the difference in policy preferences and interests between the president and prime minister, in particular those concerning the oil company Vanco's right to explore in the Black Sea, and modalities for the return of the Odessa-Brody oil pipeline to its original direction to ship Caspian oil north as opposed to Russian oil south, as it has since 2004. Crucial in each of these confrontations was the fact that in each case Tymoshenko accused the presidential entourage of supporting corrupt plans involving offshore companies – a sign of the growing mistrust between both sides on energy issues.

Such disagreements on energy policy were especially damaging given the fact that 2008 offered some promising prospects that gas relations with Russia could be regulated in a satisfactory manner, and that intermediary companies would be eliminated.

The Need to Enhance Transparency

One conclusion to be drawn from this conflict is the need to enhance transparency. Indeed, corruption and lack of transparency in Ukrainian gas markets has been a major threat to the development of a proactive energy policy in Ukraine. Lack of transparency and the corruption often associated with it has greatly contributed to the "Ukraine fatigue" that has greatly reduced Western interest in supporting Ukraine during crises. Yet as much as the West may like to point fingers at its Eastern neighbors, such as Ukraine, in matters of transparency, much work remains to be done at home. The role of Austrian and Swiss partners in the intermediary companies such as RosUkrEnergo needs to be checked much more thoroughly than it has been in the past.

Yet even more basically, the lack of a fully transparent system of gas trade – typically in the name of commercial secrecy – in Europe and other Western states means we have less to offer Ukraine than it may need in order to deal successfully with the energy challenges facing it. If such issues are not dealt with in a definite manner, there is no guarantee that, no matter what temporary solution may be found for this crisis, a similar crisis may occur before we have even recovered from the cold winter of 2009.

About the author

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Further reading

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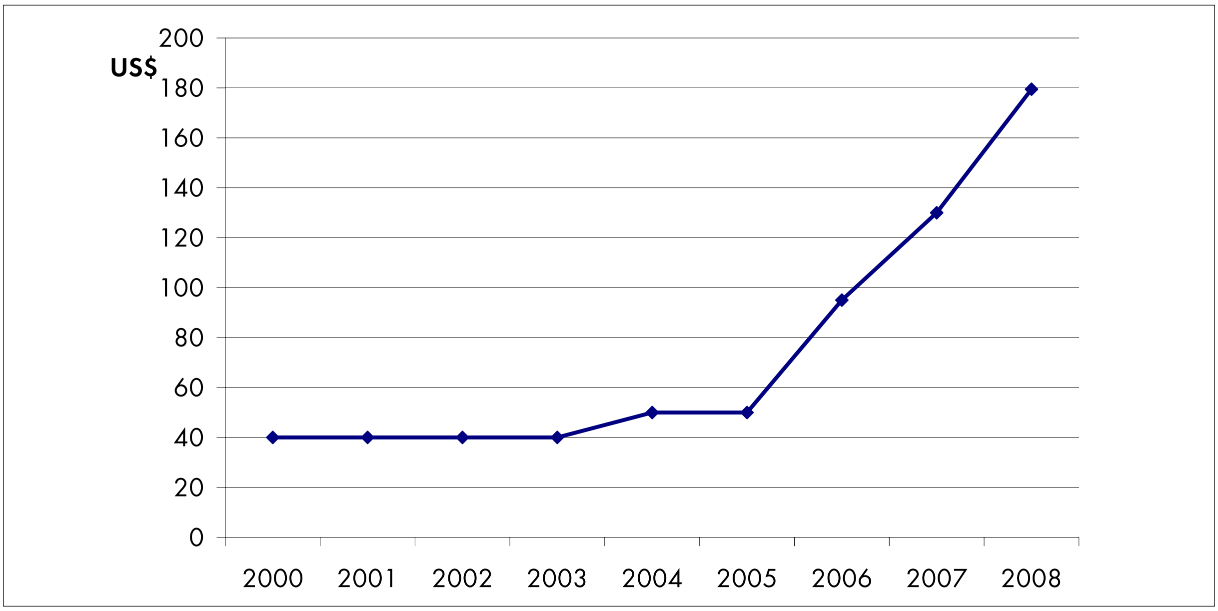
Statistics

The Russian-Ukrainian Gas Trade

Graph 1: Ukrainian Import Prices for Natural Gas 2000–2008 (US$/mcm)



Source: Institute for Economic Research and Policy Consulting, Kiew, http://ier.org.ua/papers_en/v12_en.pdf