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European Security and Russia's Natural Gas Supply Disruption

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On January 1, 2009, Russia's state monopoly OAO Gazprom began reducing gas supplies to Ukraine. Moscow and Kiev had failed to negotiate the price for natural gas, and the initial reduction affected six additional countries: Czech Republic, Turkey, Poland, Hungary, Romania, and Bulgaria. As problematic as this was, the crisis has extended beyond these initial victims. Not surprisingly, Russia is losing its reputation as a reliable supplier of gas to Europe. Motives for the Russian action include sending a signal to Europe that Ukraine should not be integrated into the Euro-Atlantic zone, but remain within the Russian sphere of influence.

The crisis demonstrates Europe's strategic dependence on Russian gas and highlights the necessity to change this situation quickly in order to prevent Europe from being taken hostage by Russia.

Failed Negotiations. Russia began halting supplies after Ukraine rejected a proposal to raise gas prices in 2009 to \$250 per 1,000 cubic meters from the 2008 price of \$179.50. This was considerably below European market price, and Russia claims that Kiev owes more than \$600 million in late fees and fines. Subsequently, Gazprom escalated tensions, saying that it initially wanted Ukraine to pay \$418 per cubic meters, and then \$450.

On Monday January 5, four days into the dispute, Prime Minister Vladimir Putin appeared on Russian television with Gazprom chief executive Alexei Miller and ordered supply to be cut by about 20 percent, withholding 65.3 million cubic meters of gas. Russia alleges that Ukraine is siphoning off an equivalent amount without paying for it.

As of January 6, 11 European countries had been affected by this disruption: Greece, Macedonia, Serbia, Poland, Slovakia, Romania, Hungary, Czech Republic, Italy, Turkey, and Croatia. Amidst temperatures as low as 0 Fahrenheit, the demand for heating is growing. Most countries have some gas storage to outlast a short disruption, but if the crisis continues for weeks, these supplies will run out.

It is clear that Russia has not ceased its efforts to use energy as a weapon, while Europe and particularly Ukraine have made themselves vulnerable by failing to diversify their energy baskets to expand the role of nuclear energy and coal, to modernize their energy-intensive industrial base to make it more efficient, and above all, to develop a coherent policy toward their Russian supplier. Europe has clearly made itself vulnerable by relying too much on Russian energy, while the national governments and the European Union failed to develop, coordinate, and implement effective policy which could have prevented the current predicament.

Energy Transit and European Dependence. Many Europeans look to Russia because Europe's own domestic gas production is in decline, while demand is likely to rise for another decade.

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Demand is projected to increase dramatically. In 2007, European demand for gas was 500 billion cubic meters (bcm) a year and is expected to rise to 800 bcm within the next decade, according to most forecasts.¹

With the largest proven natural gas reserves on the planet and a massive pipeline network built mostly in the Soviet era, Russia has a natural leverage in supplying energy to Europe. Gazprom currently provides EU members with one-quarter of its gas—about 160 bcm per year; Gazprom officials hope that this number will climb to 250 bcm per year by 2020.²

Ukraine is a key energy transit state for producers in Russia and Central Asia to European consumers. Around 80 percent of Europe's gas imports from Russia travel through Ukrainian pipelines: approximately 120 bcm per year. In turn, Gazprom receives around two-thirds of its revenue from gas that passes through these pipelines, representing 20 percent of European demand.

Germany is dependent on Russia for close to 40 percent of its gas and this number is expected to rise to 60 percent by 2020. Some European countries are entirely dependent on Russian gas, as high as 80 to 100 percent, such as Slovakia, Finland, Bulgaria, Greece, Serbia, Montenegro, and Macedonia.³ Many of the Baltic States and the Commonwealth of Independent States are also 80 to 100 percent dependent on Russian gas, such as Belarus, Lithuania, Armenia, and Georgia.

The Kremlin uses this dependence as a foreign policy tool to apply pressure against states that would adopt policies that go against Russia's national interests.⁴ Moscow has cut off supplies to numerous countries over the last seven years with Ukraine as the primary target.

Undermining Ukraine. Russia is escalating the gas crisis in order to prove to the Ukrainian people that President Victor Yushchenko and Prime Minister Yulia Timoshenko are discredited leaders, who caused energy shortages in the middle of a harsh winter. This is the price Ukrainians must pay, some in the Russian leadership imply, for pursuing a pro-Western path toward NATO membership. Russia demands that Ukraine abandon its road to NATO and the EU, and allow Moscow to base its Black Sea Fleet in the Crimea after the current agreement expires in 2017. If Ukraine runs out of gas reserves, this is a lesson many Ukrainians will not forget quickly.

Gazprom has pressured Ukraine to pay higher prices since the election of the pro-Western Victor Yushchenko. Some experts view the current price war as outright economic warfare against Ukrainian independence. Shutting off the gas to Ukraine denies the country valuable transit revenue and undermines the government's reputation as an energy transit state.

While Gazprom has raised the price of gas to most of the customers in the former Soviet Union in recent years, allies such as Armenia continue to pay lower rates, while "problem" states like Georgia pay full price.

The New Pipeline Network to Bypass Ukraine? The Russian leadership wants Ukraine to lose its leverage over Gazprom as a transit country. Moscow is hoping to make Ukraine appear an unreliable partner to the Europeans, which it believes will justify building expensive Russian-proposed gas pipe lines to Europe bypassing Ukraine. Some European governments, notably those of Germany and Italy, would now support these "direct" pipelines which bypass Ukraine, such as Nord Stream, chaired by the former German Chancellor Gerhardt

1. Robert Amsterdam, Derek Bower, and Tom Nichols, "A Prescription for Europe, Part One: Options and Opportunities for Europe to Ease Dependency on Russian Natural Gas," April 4, 2008, at http://www.robertamsterdam.com/2008/04/a_prescription_for_europe_part.htm (January 8, 2009).
2. *Ibid.*
3. U.S. Department of Energy, Energy Information Administration, "Russia, Country Analysis Brief, May 2008, at <http://www.eia.doe.gov/cabs/Russia/NaturalGas.html> (January 9, 2009).
4. Ariel Cohen, Ph.D., "Europe's Strategic Dependence on Russian Energy, November 5, 2007, Backgrounder No. 2083, at <http://www.heritage.org/Research/Europe/bg2083.cfm> (January 8, 2009).

Schroeder, and the South Stream along the Black Sea bottom. Yet, concerns over excess dependence on Russian energy, the current economic crisis, and high costs of these projects raise questions about the timetables and affordability of the new pipelines from Russia.

The astronomic price tag for both projects, over \$30 billion, makes them seem less feasible today than even a year ago. Furthermore, the pipelines proposed by the Russians would only increase Europe's dependence on Russia. The more Germany and Italy's dependence on Russian gas increases, the less they would be inclined to stand up to Russia over any foreign policy excesses.

Ukraine's Inefficient Energy Sector. Ukraine is not without blemish, as its leaders have made it vulnerable to Russian tactics and pressures. Ukraine's manufacturing sector is notoriously inefficient, producing a mere 10 percent of Germany's output, while consuming as much energy as Germany does. Ukraine's energy sector suffers from lack of transparency and from corruption, regardless of who is in power in Kiev.⁵

Swiss-registered RosUkrEnergo, for example, was in charge of marketing gas from Russia and Turkmenistan until October 2008. This company is a shady entity with allegedly illicit ties, and is an intermediary that benefits businessmen and government officials who prefer anonymity. RosUkrEnergo, like a number of other middleman companies Russia has set up in Europe, is a gas-trading company that does not own any gas fields or pipelines. It is also not the first middleman company in the Russian-Ukrainian gas trade.⁶

RosUkrEnergo was created in 2004 and is owned jointly by Gazprom and two unknown Ukrainian businessmen for the benefit of themselves and unnamed government officials. Experts have pointed out that the company appears to have links

to organized crime.⁷ Despite the lack of transparency, Gazprom has insisted on the continuing role of RosUkrEnergo in the Russian-Ukrainian gas trade. In October 2008, Ukraine and Russia agreed that their government-owned gas companies, Naftogaz and Gazprom, will deal directly with each other.

The Ukrainian state-owned energy sector remains overly politicized, mismanaged, and laden with conflicts of interests. By now, Ukraine should have taken steps to modernize its energy sector, including privatization and getting rid of the shady middlemen.

Recommendations for the Obama Administration. The Kremlin derives leverage from its control of gas production and supply networks. It uses its energy supplies to divide Europe on key issues, thus weakening Europe's bargaining power in economic and geopolitical relations with Russia. This dependence increases Europe's "continental drift" from the U.S. by limiting the foreign policy options available to America's European allies, and forcing them to choose between an affordable energy supply and siding with the U.S. and NATO on key strategic issues, such as missile defense or opposing Russia's treatment of Georgia.

U.S. interests lie in strengthening its European allies in their dealing with Russia, promoting transparency and energy security in Ukraine, and supporting Ukraine's course for Euro-Atlantic integration.

In light of these circumstances, the U.S. should:

- **Support** European diversification of energy transportation routes in Eurasia. Specifically, the U.S. should support the construction of the Nabucco pipeline which would bring gas from the Caspian basin, via Azerbaijan and Georgia, to Europe. The U.S. should oppose any excessive dependence of its allies on Russian energy exports and should encourage application of the

5. Edward Chow and Jonathan Elkind, "Where East Meets West: European Gas and Ukrainian Reality," *The Washington Quarterly*, (January 2009), pp. 77-93, at http://www.twq.com/09winter/docs/09jan_ChowElkind.pdf (January 9, 2009).

6. Roman Kupchinsky, "Gazprom Stops Gas Deliveries to Ukraine—What Next?" *Eurasia Daily Monitor*, Vol. 6, No. 1 (January 5, 2009), at http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=34303&tx_ttnews%5BbackPid%5D=7&cHash=8c76dd24ee (January 8, 2009).

7. Roman Kupchinsky, "Russian Energy Sector Opaqueness," testimony before the Senate Foreign Relations Committee, U.S. Senate, June 12, 2008, at <http://foreign.senate.gov/testimony/2008/KupchinskyTestimony080612p.pdf> (January 8, 2009).

European anti-trust legislation against Gazprom. It will also be necessary to encourage EU members to establish and implement a joint policy on their dealing with Moscow in the energy sector.

- **Encourage** Europe to construct more liquefied natural gas (LNG) terminals, importing gas from Qatar, Algeria, and Nigeria, thus diversifying the sources of gas. Moreover, Germany, Italy, and other countries in Europe should be encouraged to develop coal, nuclear power, and competitive renewables as sources of affordable electricity.
- **Support** Ukraine's efforts to modernize its energy sector, including reforms to increase transparency and energy efficiency, privatize and liberalize oil and gas sectors, depoliticize management, and decisively remove middlemen in energy transactions.

Time to Face the Cold Facts. As frigid Arctic winds blow across Europe, it is time to face the cold facts: Dependence on Russian gas is undermining European security. Russia is likely to use its energy muscle to impose its geopolitical agenda on its neighbors, today and in the future. To change this situation, European countries, including Ukraine, need to work with the United States to diversify sources of energy and stand up to Russian bullying.

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