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EU Plays Hardball With Russia on Gas Issue

By John Lough

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Although the European Union, Ukraine, and Russia have yet to reach an agreement on Ukraine's gas bill, over the past several weeks it has become clear that the EU holds strong cards in its gas relationship with Russia and is using them effectively.

The Bulgarian government last week bowed to the inevitable, accepting the demands of the European Commission to suspend construction of their parts of Gazprom's South Stream pipeline designed to bypass Ukraine and bring Russian gas to Europe via a new southern corridor.

The Commission has ruled that the intergovernmental agreements underpinning South Stream with all the countries along its route, which include Bulgaria, Serbia, Hungary and Slovenia, do not comply with EU competition law and require revision before the pipeline can be built.

The Commission has also, and perhaps more pointedly, begun to investigate the tender process that led to the award of a $4.7 billion contract for the construction of the Bulgarian section of the pipeline to a consortium headed by the Russian company Stroytransgaz. Stroytransgaz's owner is sanctioned billionaire and Putin ally, Gennady Timchenko.

Sofia's decision is a blow to Russia that will delay its long-standing effort to separate its relations with Ukraine from its European gas business. If built, South Stream's capacity of 63 billion cubic meters per year will reduce Russia's gas transit dependency on Ukraine to zero by 2020. Russia currently exports around 50 precent of its gas supplies to Europe through Ukraine, and the alternative route offered by South Stream would deprive Ukraine of a critical source of influence in its relationship with both Russia and Europe.

Of course, not all the countries through which the South Stream pipeline passes have bowed down to EU pressure. After meeting with his Serbian counterpart, Russian Foreign Minister Sergei Lavrov stated that Serbia would begin building its stretch of the pipeline next month.

By challenging the legality of South Stream, however, the Commission has kicked the project into the long grass and forced Russia to seek an alternative solution to the vexed issue of gas transit through Ukraine.

In a bid to avoid another gas crisis, President Vladimir Putin invited EU leaders to support a negotiation between Russia and Ukraine to ensure the delivery and transit of gas.

This led to several rounds of talks between Russia and Ukraine mediated by EU Energy Commissioner Günther Oettinger that began in May and have so far led to Ukraine paying off $786 million of its gas debt to Russia that Moscow claims is now $4.4 billion.

The key issue unresolved issue is the price formula for future gas sales. Russia claims that according to the 2009 gas contract, this should be $485 per 1,000 cubic metres. Ukraine counters that $268.5, or the price that it previously paid when discounts applied, is a fair price that is profitable for Gazprom. Gazprom's European customers pay about $370 per 1,000 cubic metres..

Russia's latest offer is a $100 discount for each 1,000 cubic metres on the 2009 contract price but the Ukrainian government is demanding a new price as part of a new contract. It argues that a discount price on the current contract can be cancelled arbitrarily on political grounds, as was the case after President Viktor Yanukovych was deposed in February.

Both sides are threatening the other: Russia says it will force Ukraine to pay in advance from June 16 for its gas unless it clears its gas debt up to April 1 in full. Ukraine has said that if it cannot agree a new price with Moscow, it will go to arbitration in Stockholm.

However, Ukraine is dependent for economic survival on IMF financing that is conditional on action to address unaffordable gas subsidies.

Second, Russia's annexation of Crimea and its role in destabilizing the southeast of the country have encouraged Ukraine's leaders to sign an association agreement with the EU and significantly increase trade and economic integration with Europe.

These twin pressures are impelling the Ukrainian authorities to start genuine reform of the country's notoriously murky energy sector for the first time.

The EU has called for installation of gas metering stations at the Russian-Ukrainian border to establish reliably how much gas Russia is supplying to Ukraine. A lack of transparency in this area has benefited Russian and Ukrainian business interests for many years.

The EU is deploying other instruments as well: it has frozen an exemption granting Gazprom full access to the OPAL pipeline running through Germany to the Czech border that feeds off the Nord Stream pipeline.

This effectively incentivizes Gazprom to keep supplying gas through Ukraine and to agree a price with Kiev for gas sold to Ukraine. The Commission is also quietly pursuing its anti-trust probe into possible market abuses by Gazprom that could result in a heavy fine.

Paradoxically, for all its capacity to buy influence and create chaos in Ukraine, Russia has shown that it needs the EU's involvement in resolving its gas dispute with Kiev.
An interdependent energy relationship between the EU and Russia that has so often seemed weighted in Russia's favor looks less so at present.

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