Natural Gas and the Ukraine Crisis
FROM REALPOLITIK TO NETWORK DIPLOMACY

PONARS Eurasia Policy Memo No. 338
August 2014

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The current crisis in Ukraine has again foisted natural gas diplomacy to the fore of great power politics. Many view the gas weapon as Moscow’s continuing trump card for coercing Kyiv with impunity and keeping Europe at bay. As was the case during the 2006 and 2009 gas wars, the asymmetric trading relationships and state control over the Russian gas monopoly, Gazprom, seem to present Vladimir Putin’s regime with an effective resource nationalist stranglehold to advance a broad neo-imperial agenda. Concerns range from Moscow laying claim to energy fields off the coast of Crimea, to exerting pressure on rival Eurasian energy suppliers, to subverting European Union governance by manipulating splits among unevenly dependent member state consumers, to playing off Europe and Asia with construction of the Russia-China gas pipeline, to exploiting transatlantic differences more generally in a run-up to Cold War 2.0.

Others, however, view the tectonic shift in the global gas landscape—capped by burgeoning liquefied natural gas (LNG) trading, changing political geography of supply and demand, and booming unconventional production in North America—as facilitating more aggressive responses to Russia. Sensing that Moscow now has the most to lose by a gas showdown and shrunken energy rents amid an already listing economy, Western pundits and policymakers herald the strategic merits of slapping comprehensive sanctions on Russia’s energy sector, fast-tracking U.S. LNG exports, forging European collective purchasing power, diversifying import routes and suppliers, and accelerating non-fossil fuel economies to free Europe from Russia’s steel umbilical cord. Major Western energy companies and their political patrons are castigated for lacking national fortitude and indulging parochial interests by signing follow-on ventures with Gazprom and keeping alive the South Stream pipeline that would circumvent Ukraine to deliver larger volumes to Europe. Similarly, failure to redress a widening gap between these emerging market realities and current policy inertia supposedly dooms the West to self-defeating and feckless diplomacy toward
Russia. Buoyed by the apparent success of oil sanctions at bringing Iran to the bargaining table on nuclear issues and appalled by Moscow’s callousness following the tragic downing of flight MH-17, a broad consensus among U.S. and European policymakers is coalescing to support a realpolitik corrective that includes ratcheting up coercive pressure on Russia’s energy sector.

Yet, there are two core problems with these opposing narratives. First, the current crisis is distinguished by restraint on all sides. Unlike the episodes in 2006 and 2009, Russian gas deliveries to Ukraine and transit to European markets were not arbitrarily disrupted at the apogee of the recent political conflict. Gas continued to flow through mid-June 2014, notwithstanding the annexation of Crimea, the unraveling of political authority in Ukraine, and the flow of pro-Russian fighters and weapons across the border. The cut-off eventually imposed by Russia occurred after negotiations began and substantive differences narrowed, and (to date) without causing supply shortfalls in Europe. This suggests greater resilience, if not potential for accommodation, on gas issues than acknowledged by either side of the debate.

Second, fixation on new production and changing global gas flows overlooks the geopolitical significance of an emerging Eurasian gas network. This transformation is remaking influence, vulnerability, and stability in transnational relations at the national and corporate levels. If embraced, this could afford new opportunities for Western leaders to coordinate and sustain pressure on Russia while offering possible off-ramps for future engagement.

Is a Gas War a Gas War?

Physical disruptions in Russia’s gas supply to Ukraine and Europe have been seemingly overdetermined, given Kyiv’s vulnerability owing to dependence (up to 60-80 percent) on subsidized imports from Russia; Ukraine’s position to hold up transit of Gazprom’s deliveries (50-80 percent) to Europe and Europe’s willingness to construct new pipelines that bypass Ukraine while deepening its co-dependency on Russian gas (30 percent of EU imports). Soviet legacy pipelines, which lack the disciplinary focus on recouping returns on investment, and pervasive domestic institutional and regulatory opacity stoke non-commercial risk-taking and credible commitment problems in contracting for all related stakeholders.

Yet, the bargaining contexts have varied considerably between these gas wars. In 2006 and 2009 the stakes were primarily commercial with political undertones. This time around, disputes over gas prices, volumes, and rents have taken a back seat to issues of national sovereignty, regime survival, territorial integrity, and strategic orientation in what has devolved into the gravest confrontation between Moscow, Ukraine, and the West since the Cold War. Furthermore, Gazprom arguably enjoyed more of a free hand to deal assertively with Kyiv and insulate itself from European blowback in the lead up
to the current crisis, owing to the drop in revenues from EU sales and the opening of the Nord Stream pipeline to Germany.

For all the clamoring about gas as a potent instrument of foreign policy, and in contrast to the showdowns in 2006 and 2009, none of the central players rashly escalated the current gas conflict. Russia’s resurgence and penchant for predatory pipeline politics notwithstanding, Moscow refrained from precipitously shutting off supply or coercing an increasingly indebted and enfeebled leadership in Kyiv into conceding equity stakes in Ukraine’s national gas company. The Kremlin confined its early energy diplomacy to extending (and then not renewing) price discounts, while repeatedly softening ultimatums issued by Gazprom through the election of a new Ukrainian president. Even as it cut off direct supply to Ukraine in mid-June 2014 and demanded repayment of Ukraine’s accumulating gas debt and pre-payment for future deliveries, Moscow offered binding price discounts via lowered export duties for the duration of a future contract.

Similarly, neither the embattled interim or newly elected governments in Kyiv nor diverse non-state actors (such as organized criminal elements, regional oligarchs, or corrupt officials) with opportunity to step into the widening power vacuum across Ukraine arbitrarily disrupted transit of Russian gas to Europe, even as their options narrowed and stakes mounted. Although Kyiv fell deeper into arrears, unilaterally abrogated the “take-or-pay” terms of the standing contract with Gazprom, faced direct cutoffs, and balked at Moscow’s calculation for settling the debt and demands for pre-payments, it did not openly exploit Russia’s dependency on European markets by withholding transit throughput. Like Moscow, it too has been willing to negotiate new prices and settle grievances either in or out of international court.

Restraint also has characterized the Western response. As Washington and Brussels struggled early on to demonstrate resolve and tighten sanctions on Kremlin cronies, they purposefully avoided boycotting key Russian energy interests at an otherwise propitious moment when spring was coming, storage facilities were flush, demand was decreasing, and supply options were expanding. Even after Russian gas was shut off to Kyiv and tempers flared over the escalation of military offensives and civilian casualties in pro-Russian rebel-held territory, the harsher measures imposed by the United States and the EU at the end of July still shied away from wider “sectoral sanctions” and mostly spared Russia’s gas industry.

Often overlooked is that energy ties deepened from fall 2013 through spring 2014. While Russian gas supplies to Europe reached historical highs by the end of 2013, Ukraine received temporary energy discounts and advanced payment of transit fees through 2014. European companies, too, finalized international equity swaps and joint commercial ventures with Gazprom and other Russian energy companies just as Washington and Brussels imposed asset freezes, visa bans, and targeted sanctions. This mixed bag of gas diplomacy poses problems for contending realpolitik and
interdependence paradigms that warrant closer attention to the changing regional gas landscape.

**An Emerging Eurasian Gas Network**

While it is premature to unpack decision making in the current crisis, a distinguishing feature is that events are unfolding as multiple pipeline and LNG import facilities, interconnectors and reverse flow options, new gas storage facilities, and a deepening of cross-border commercial ties are converging to constitute a Europe-Eurasian gas network. This increasingly dense infrastructure is marked by the interaction of mature and new hubs where gas is produced, traded, and re-routed to various locations of demand across Europe. The integration of these hubs that receive piped gas from Russia and other Eurasian suppliers, import and distribute LNG, and concentrate vertical integration with other power and transportation sectors effectively reduces the exclusivity and average path length of exchanges, as well as creates opportunities for brokerage between old and new upstream and downstream partners. The result is to add flexibility, resilience, and competition to intra-network gas markets. These trends are reinforced by well-established, strong, and cross-cutting political and corporate-level relationships between these hubs. The latter constitute the grist for building trust and securing access to energy markets and resources across the network that transcend different company ownership types and formal institutional and regulatory voids at national and EU levels.

Notwithstanding the blows to Gazprom’s monopoly position, Russia will be a supply anchor within this network for the foreseeable future. With knife-edged differences among competitors in the global economy, European utilities, firms, and states are acutely sensitive to fluctuations in price. Soviet legacy investment, production, and large-diameter cross-border pipelines effectively reduce actual production and delivery costs, ensuring Gazprom suitable margins for delivering gas to Europe in comparison to the building of rival pipelines from Central Asia or covering high LNG break-even costs. But the daunting financial and technical challenges of bringing new Russian fields online, coupled with the diversity of supply, burgeoning intra-regional trade, and uncertainty of EU demand, are dampening Moscow’s ability to strong-arm downstream customers, especially as long-term supply contracting turns on future expectations.

The emergence of satellite hubs within the EU also creates opportunity for incremental competition with Russian imports. The Baltic states and Poland, for example, constitute a North-Central European hub with development of related LNG facilities and interconnectors southward. Slovakia is becoming another important hub for alleviating pressure within the network, as it is the EU member best situated to “reverse” the flow of gas to Ukraine, plug into Hungary’s gas grid, and link up to a newly constructed Polish LNG plant and connectors to Polish and the Czech transmission systems (as well as the burgeoning Southern Corridor for delivering Caspian gas).
The Ukraine crisis has further illuminated the intensity of inter-state corporate ties between European and Russian gas entities. Leading energy companies across Europe—obliged to earn profits for their shareholders—rely increasingly on long-standing and trusted business partnerships with Gazprom and their experience of reliable supply to navigate the uncertainty of the changing landscape. As international tensions mounted and sanctions were imposed, some of these largest multinational energy stakeholders “doubled down” on gas investments, staved off more stringent restrictions on existing projects, and forged closer business ties with Gazprom.

The transformation from predominantly point-to-point pipelines to a regional gas network is changing the dimensions of dependence, accentuating both market constraints on unilateral supply disruptions and indirect opportunities for political gamesmanship. Paradoxically, this network constrains Russia’s market power while preserving its salience as a valued commercial partner. At the same time, it is giving rise to new hubs and clusters of trading that are dampening incentives for discretionary coercive behavior while discouraging defection from established transnational business ties.

**Recommendations**

Failure to appreciate this widespread restraint and the changing European gas system that render dyadic Cold War paradigms anachronistic is strategically counter-productive. It is a recipe for uniformly escalating mutual pain, encouraging evasive counter-measures, and fueling the Kremlin’s resolve. Instead, a network perspective on gas suggests new directions for pursuing a more nuanced, coordinated, and market-friendly grand strategy aimed at changing the situation “above ground,” and bolstering Western resilience at ramping up pressure on Moscow while leaving open the possibility of future constructive engagement with Russia.

With tighter sanctions already in place, the focus for Western policymakers moving forward should be on damage control that accentuates the density of the emerging European gas network. Promoting transparency and market reforms, as well as introducing targeted tax breaks and favorable lending terms and guarantees, should be the guiding principles. This could allow Western governments to accelerate investment directly in the construction and integration of the gas infrastructure and facilitate price correlation across European hubs that the ongoing recession and market itself may be slow to deliver. This also can strategically attract the Western investment redirected from the sanctions and Moscow’s retaliation to bolster inter-regional flows and price efficiency for spot market trading. Rather than confront the strong ties—both among emerging European hubs and Moscow and among Western and Russian firms—with even harsher sanctions, officials in Washington and across the EU should embrace
market trends by promoting diversified and competitively priced deliveries both into and within the European gas network.

Western policymakers also would be wise to signal energy options for incrementally defusing the current political crisis, making clear that the door will be open for engaging commercially competitive Russian gas interests as tensions ease. This could include reaching out to Russia’s rising gas independents to extend reciprocal influence forged out of historical relationships working with Moscow. Down the road, different Russian firms and their local partners/subsidiaries could be invited to join in the development of diversity via new storage facilities, decoupled pricing, access to transmission lines, and shale exploration. This could limit Gazprom’s room to maneuver while increasing the standing of new Russian stakeholders in gas-on-gas competition across the continent. It also could facilitate, on the margins, the tough decisions needed in Moscow to return to pre-crisis liberalization of the gas industry at home. As such and amid the bitter acrimony and scars of post-Soviet conflict—energy and otherwise—the deepening regional gas network affords opportunity to demonstrate goodwill and re-ground pragmatic transatlantic-Russian relations moving forward.