

# Alternative Interpretation of the Russian-Ukrainian Gas Crisis

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The month-long conflict between Russia and Ukraine over the price of Russian gas has pitted images against policy. In recent years, the image of Russia has been largely negative while the image of Ukraine after the Orange Revolution of 2004 has been largely positive. Consequently, Western sympathies were, by and large, on the side of Ukraine. Russia's behavior was seen as arrogant and unreasonable. The reduction of gas supply to Europe on January 1 and 2, 2006 was blamed squarely on Russia as well. Yet, a closer look suggests that more than one interpretation of this crisis is possible and, furthermore, in this particular case Russian policy was perhaps not unreasonable, even though badly executed, and was in the long-term interest of the international community and even Ukraine.

## **The Path to the Showdown**

Gazprom proposed new prices for 2006 as early as June 2005, with some Russian sources citing March 2005. The proposed price for gas was to be \$160 per 1,000 cubic meters (increased from \$50), while Gazprom would pay \$1.75 per 1,000 cubic meters of gas for 100 km of transit through Ukraine (as opposed to \$1.09). All payments were to be made in cash (until 2006, transit was paid for by gas). Gazprom justified the new proposal by the vastly increased world price for gas. According to its calculations, the 2006 price for European Union customers was set around \$255 per 1,000 cubic meters.

Several other Gazprom customers faced similar hikes: Georgia from \$63 to \$110, Moldova from \$80 to \$160, and the Baltic states from \$80 to \$120-125. Only the price for

Belarus remained the same at \$47.

Judging by the available information, Ukraine bided its time until early December 2005, when Gazprom went public and threatened to cut the supply of gas to Ukraine on January 1, 2006, unless new prices were accepted. In response to Gazprom's threat, Ukraine made a series of counteroffers ranging from \$65 to \$100, threatened to take Russia to the Stockholm arbitration court, and called on the EU and the United States for help against Russian pressure.

Ukraine's key success at that stage was its ability to convince the West that Gazprom was in violation of contract. The claim that Russia violated the 2004 Protocol No. 4 (a supplement to a 2002 agreement on the sale and transit of gas), which stipulated the price of gas at \$50 until 2009, was not fully accurate, though. The relevant Russian-Ukrainian agreements distinguished between two categories of gas deliveries. According to the 2002 agreement the price of gas *sold* to Ukraine was set annually by a special protocol, while the price of gas delivered as payment for transit was set by Protocol No. 4 at \$50. Thus, Gazprom had the legal right to change the price of gas sold to Ukraine. Its proposal to *increase* payment for transit and pay in cash instead of by gas was, indeed, a violation of Protocol No. 4, but it echoed earlier statements by Ukrainian officials. Gazprom failed, to articulate its position, however.

Gazprom instead resorted to a Don Corleone tactic (lifted straight from *The Godfather*) in response to Ukraine's counterproposals and accusations, and increased the proposed 2006 price to \$220-230. That price, it said, was calculated by using the same formula employed for EU customers.

As negotiations with Russia continued, Ukraine urgently signed a contract with Turkmenistan to receive 40 billion cubic meters of gas in 2006 and even agreed to a last-minute demand by Turkmenistan to increase the price from \$44 (set by a June 2004 agreement) to \$60. Russia had signed its own agreement with Turkmenistan shortly before Ukraine, also at a higher price.

Ukrainian officials also tried to use another bargaining chip against Russia, threatening to increase the rent for the Russian naval base in Sevastopol. However, the Russian minister of defense, Sergei Ivanov, immediately threatened to reconsider the entire 1997 treaty, which, in addition to solving the issue of the naval base, also recognized Crimea as part of Ukraine.

Gazprom turned off the spigot on January 1 but continued to pump just enough gas into the system to satisfy its European customers. Hours later some of these customers reported a reduction of deliveries. Gazprom blamed Ukraine for siphoning gas, but Kyiv stated that no "unauthorized diversion" was taking place. On January 3, Gazprom increased the amount of gas pumped into the system to restore the supply to Europe. Only then did Ukraine admit to diverting gas, but said this was gas it was scheduled to receive from Turkmenistan. The reduction of supplies tarnished Gazprom's reputation. By failing to pump gas in payment for transit Gazprom apparently committed the only substantive violation of contract during the whole crisis. Curiously, however, Ukrnaftogaz did not classify the diversion as payment for transit, implicitly accepting Gazprom's logic.

On January 4, the two sides reached a five-year agreement. The price for Russian gas was set at \$230, but Gazprom would sell it to a newly created intermediary (consisting of RosUkrEnergo, a Swiss company established by an Austrian bank, and Ukrnaftogaz), which would mix Russian gas with gas delivered from Turkmenistan and other Central Asian states and sell the mix to Ukrnaftogaz at \$95. The price for transit was set at \$1.60.

Compared to the original Gazprom proposal, the deal contained some significant deficiencies. First, it included RosUkrEnergo, a notoriously closed entity widely suspected of shady deals with participation from both Russian and Ukrainian officials. Second, the arrangement lacks flexibility: there are no guarantees that Ukraine will buy any gas from the intermediary at all. Almost immediately after signing the new deal, Andrei Lopushanski of Ukrnaftogaz said Ukraine might not even need Russian gas in 2006. Gazprom is likely to insist on including more expensive Russian gas in such deliveries, however. Also, Turkmenistan might want to increase the price further for the second half of 2006, driving the price of the mix sold to Ukraine beyond \$95.

Furthermore, Gazprom might resort to the same tactic as Ukrnaftogaz and begin to divert Turkmen gas. It has a contract for 30 billion cubic meters of gas in 2006 from Turkmenistan, and the capacity of the pipeline from Central Asia is only 48 billion cubic meters per year. If Gazprom decides to take all the gas it is entitled to, Ukraine will be left with only 18 billion cubic meters and be forced to buy more gas from Russia.

## **Blackmail or Recognition of Independence?**

Ukrainian officials promptly classified Russian behavior as political blackmail and revenge for the country's pro-Western choice following the Orange Revolution. President Viktor Yushchenko declared that the very independence of his country was at stake.

This assessment was, by and large, shared by the EU and the United States. U.S. Secretary of State Condoleezza Rice called Russian policy "politically motivated" and added that "the game just can't be played that way." This attitude is understandable: Russian attempts to interfere with the 2004 presidential elections in Ukraine, the sharply negative attitude toward the Orange and other color revolutions, an unconcealed negative attitude toward the pro-Western orientation of Ukraine—all this has made the West highly suspicious of attempts to use gas supplies to enhance pressure on Kyiv in the run-up to the parliamentary elections in March 2006.

The logic of Russian actions, however, seemed to embody a different causal chain. Instead of trying to bully Ukraine into the Russian sphere of influence, Moscow apparently had given up on Ukraine. Explaining Gazprom's move, Vladimir Putin said on December 8 that Russia no longer wanted to economically support Ukraine (he estimated projected Russian losses at \$4.6 billion in 2006) and sarcastically noted that considerable economic assistance from the United States and the EU enabled Ukraine to pay for gas at world rates. Effectively, he refused to assist Ukrainian efforts to join the EU and NATO.

This new "pragmatic" approach to the "near abroad" was announced by Russian foreign minister Sergei Lavrov in August 2005. Henceforth, he said, Russia would use

“international norms and rules” in relations with post-Soviet states. A day later, an “anonymous source in the Kremlin” clarified that “full independence” carried a price: countries that did not respond to Russian interests would no longer enjoy economic benefits in the form of lower oil and gas prices, trade preferences, and so forth. As noted above, new prices applied to a host of countries that Moscow does not classify as “friends”—including Ukraine, Georgia, and Moldova.

The new policy does not apply to gas alone. In early December 2005, the Russian state-owned company TVEL, which sells nuclear fuel to Ukraine, announced that it was seeking to increase the price of fuel. The rationale was similar to that offered by Gazprom: while the price of uranium had risen from \$25 to \$88 per kilogram, it was selling nuclear fuel to Ukraine at the old price. TVEL claimed that it was losing about \$150 million a year. In the same category is the ban on the import of citrus products from Georgia or restrictions on guest workers.

The key tenets of the new approach seem quite straightforward. All post-Soviet states are divided into two groups. The first, political and/or military allies, is defined by membership in various international organizations, such as the Collective Security Treaty, the Joint Economic Space, and the Shanghai Cooperation Organization (SCO). These states enjoy a variety of economic and political benefits and incentives, including a lenient attitude toward the way they treat their Russian-speaking populations.

The other group consists of states that have decided to abandon their post-Soviet past and seek entry into organizations such as the EU and NATO. These states will be treated in the same way as other countries, including those that formerly belonged to the Soviet bloc; this means that the attitude toward them will be considerably worse than that toward Old Europe.

Russia is also trying to reduce its own dependence on these countries. It is apparently prepared to assume economic costs, which, in any case, are expected to be lower than the benefits of market price-based trade. The decision to withdraw military bases from Georgia belongs to the same trend as well. Undoubtedly, some vulnerabilities are bound to remain. For example, Russia wants to keep Sevastopol as the base of its Black Sea fleet, as well as retain access to data from the Sevastopol and Mukachevo radar stations.

Two countries in the post-Soviet space remain in the grey area: Turkmenistan, which does not belong to either group, and Azerbaijan, whose allegiance is still unclear and which carefully steers its way between Russia and the West trying to reap benefits from both. Kyrgyzstan, notwithstanding its agreement to retain a U.S. military base in its territory, seems to be listed in the Russian camp.

Eventually the notion of post-Soviet space might disappear altogether as countries outside the area might join the “pro-Russian” camp. For example, Iran’s close relations with Russia and its observer status in the SCO put that country into the same category as Central Asian states. The contract to sell advanced air defense systems to Iran demonstrates an intention to further enhance relations with Teheran. This plan, supported by both Russia and China, might fall victim to the controversy over the Iranian nuclear program, though.

It took Moscow a long time to reconcile itself with the loss of part of its sphere of influence, but once the decision was made implementation was quick and decisive – hence, the abrupt introduction of new prices and the refusal to compromise or to agree on a gradual transition. As a result, Russia’s behavior is often arrogant and high-handed. Certainly, it openly flaunts its position of power vis-à-vis its neighbors.

There is also, perhaps, one more reason for this style: a deep-seated fear of repeating the previous retreat, in the late 1980s, when the Soviet Union did not gain political or economic benefits from abandoning its geopolitical positions and instead incurred significant economic losses. The Gorbachev-Shevardnadze principle of acting “in the common good of humanity” or “making concessions to common sense” is no longer deemed acceptable. The preferred mode is, instead, tough bargaining and attempts to maximize economic benefits. Undoubtedly, this style of policy adds to the already largely negative image of Russia.

In contrast to Russia’s strategic shift, Ukraine’s goals with regard to the gas crisis were limited to maintaining favorable economic conditions as long as possible. Its leadership proclaimed interest in a transition to market prices, but only gradually; in any case, its idea of market prices was different than Russia’s. In December 2005, Yushchenko said that the fair market price was about \$80 per 1,000 cubic meters, one-third of what EU customers pay for Russian gas.

Ukraine’s position was rational from the cost-benefit perspective, but it was counterproductive in a broader sense, as it effectively sought to preserve an anachronistic scheme inherited from the immediate post-Soviet period, when Russia and Ukraine were locked in a symbiotic relationship. Strategically, it was in Ukraine’s own interest to go along with Russian determination to treat it as a fully independent state and accept higher prices for gas. This is especially true because, as it turned out just days after signing the new gas deal, Ukraine does not really need Russian gas, whether at \$160 or \$230 per 1,000 cubic meters. At worst, it could have sought assistance from the EU and possibly the United States to end its dependence on cheap Russian gas at the earliest date.

## **Implications for the United States and the European Union**

Three decades ago, Robert Jervis published a seminal book warning against letting perceptions influence policy. The case of the Russian-Ukrainian crisis over gas seems to bear out his conclusions. Images by and large dominated the West’s assessment of the events while the implications of Russian policy for the future of Europe, including the territory of the former Soviet Union, have been largely missed. Perhaps this policy was worth supporting, or at least tolerating, since its purposes and consequences were fundamentally in agreement with the desire of Ukraine and some other post-Soviet states to break with their Soviet past and join international organizations of their own choosing.

Accordingly, the optimal Western, especially EU, response should have been to mitigate the negative effects of the transition to new gas prices by offering Ukraine economic assistance. In this case, Ukraine could have accepted the initial Russian offer of \$160, and the overall deal would have been more transparent.

The Russian-Ukrainian crisis serves as yet another reminder that sound policy could originate from unlikely places.

The price of (mis)interpretation might not be immediately apparent, nor tangible. The Western attitude toward the affair did apparently surprise the Russian leadership, however, and was seen as a manifestation of the overall hostility of the West. This perception is all the more harmful for U.S.-Russian and EU-Russian relations since the Kremlin's new policy seems to enjoy widespread support in the country (unlike many of its other policies), especially against the background of stalled relations with the EU and a negative perception of the Organization for Security and Cooperation in Europe and the Council of Europe, as well as the European position on Russian-speaking minorities in the Baltic states. It is likely that the negative perception of the West will continue and strengthen.

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