



Ukraine-Russia gas spat: some background and context

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As we enter yet another episode of worried or sanctimonious articles about the gas conflict between Russia and Ukraine, it's worth remembering a few simple facts:

- 1) The conflict started in 1992, not in 2006;
- 2) Russia cannot win a gas war against Ukraine and knows it;
- 3) the real underlying stakes are not about Russia or Ukraine.

1) The conflict started in 1992, not in 2006

A given in most of the coverage of this episode is that these things have been happening over the past few years only. Everybody remembers the 2006 episode 3 years ago, which brought the issue to global awareness, and most coverage seems to think that this is when it all started. It's not. Russia and Ukraine started squabbling about gas as soon as the Soviet Union broke up, ie from 1992. There were cuts to gas deliveries to Western Europe in 1992 and 1993, which led the major importers - the GDFs, Ruhrgas and SNAMs - to set up offices in Kiev to try to understand what was going on and to bring pressure on the then new country of Ukraine to not interrupt gas deliveries.

I spent half a year in GDF's Kiev office in 1994, where I painstakingly collated local sources to prepare a report on the Ukrainian gas industry, and picked up most of the content for my PhD dissertation on the independence of Ukraine and its relationship with Russia, both of which were defined largely by gas. I've never been able to ascertain that Ukraine actually ever paid anything for gas to Russia then or since.

The reality is that the Soviet gas industry was born in Ukraine in the 1930s, and the infrastructure was built from there and Ukraine is still a central part of the gas pipeline network even as the focus of activity moved to Western Siberia. Splitting the Soviet Union along Republic borders made for an often unworkable allocation of physical assets, and nowhere was this more true than for gas. The consequence is that vital assets for Gazprom are located in Ukraine and thus no longer under its direct control.

The ties between the industry in the two countries are thus massive, impossible to unwind, and highly constraining. Effectively, as soon as there is a conflict between the two countries, the temptation to use the "gas weapon" (ie to hurt the other by, in the case of Russia, withholding gas or, in the case of Ukraine, withholding export infrastructure) is large - and it has happened repeatedly, until, each time, cooler heads prevail.

So you could go back and look into Ukrainian and Russian papers from any date over the past 17 years and find that they have articles about unpaid Ukrainian debts for gas (which, since 1992, have for some reason always been in the \$1.5-2 billion range) and bilateral brinkmanship. Yet

So why do we think that the conflict started in 2006? Well, it's just that we started to care that year, for some easy-to-identify reasons:

- The 2004 orange revolution put Ukraine on the map, as a new, spunky member of the "democratic world" against the axis of evil and other assorted dictatorships, a group that Russia was beginning to join in the White House view. Never mind that Yushchenko was initially more pro-Russian than Yanukovich, hardliners in both the US and the Kremlin were happy to play this as a West vs Russia fight and it de facto became one. Suddenly, the arcane gas disputes that only a few buyers cared about became the battlefield between two large blocs, and one that the West™ cared about.
- The run up in oil prices since 2003 has had an impact on gas prices (Russia's gas is sold to Europe at prices indexed, with a lag, to oil prices) and more generally on how much attention we give to energy-related issues. For Russia, the urge to get more money out of the gas delivered to Ukraine was growing; for the West, the attention paid to energy supplies similarly got more priority.
- More importantly, 2006 is the year when the UK became, it seems unexpectedly for its political leadership, a gas importer rather than a gas exporter. Suddenly, for the first time ever, security of gas supply became an issue for English-language experts. Somehow, this turned into *Europe's* dependency on Russian gas and Ukrainian transit being a big deal - never mind that Western Europe has been importing Russian gas for 40 years and that companies like GDF and Ruhrgas have been aware of the delicate situation of Ukrainian transit for 15 years.
- Almost at the same time, 10 Central and Eastern European countries joined the EU. As the majority were former Soviet satellites (or even Soviet Republics), they are very wary of Russia and most of them are highly dependent on Russian gas, because their supply infrastructure was built in the context of the COMECON. While they are not all in the same situation (in particular, transit countries have a lot more leverage), they have certainly encouraged the EU to focus on Russian gas supplies a lot more closely, and a lot more adversarially.

While these recent factors can explain why it's not unreasonable to care more today than in the past about the underlying conflict, there is no excuse not to provide the relevant context, ie that this is a long, simmering dispute that has no good guys and no bad guys and which has very little to do with us.

2) Russia cannot win a gas war against Ukraine and knows it

The most important bit of information that would need to be provided is why this conflict happens in the first place, and how it's been resolved in the past.

The reality of Soviet legacies is that Ukraine has a lot of vital Soviet-times gas infrastructure (the pipelines are an obvious item, but, just as significantly, Ukraine controls most of the storage capacity of the Russian export system, something rather important when you know that winter gas demand is 2-3 times summer demand and pipelines can be made smaller if you can ship gas all year long and store it close to markets for winter use). It is also a heavy-industry country, with very high gas demand. It has also mostly depleted its gas reserves, making it heavily dependent on gas from Siberia.

So there is a strong co-dependency, with Russia needing Ukrainian infrastructure to honor its export contracts to Europe, and Ukraine needing Russian gas. In the early years, there were additional constraints, such as the only Soviet manufacturer of large pipes used by Gazprom being in Ukraine, the only manufacturer of medium sized pipes (needed by the Ukrainians) being in Russia, and gas going to Southern Russia needing to flow through Ukrainian territory. I have

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Ukraine used to get its gas allocation from Soviet planners, and continued to expect the same after independence. When Russia first tried to get payment for its deliveries in the early 90s, it failed; when it first cut off gas to Ukraine to enforce payments, Ukraine simply tapped the gas sent for export purposes in Ukrainian-controlled pipelines; when European buyers howled, Russia relented and restored gas supplies without having managed to be paid by Ukraine. This happened repeatedly in 1992-1994 until both sides learnt not to make their disputes as public (*ED: "not" added in last sentence*).

The exact same thing happened over the years, but more discreetly. 2006 marked a change in that the dispute was thrust into the limelight once again, but fundamentally the same thing as before happened. The proof of this in January 2006, Russia restored deliveries **before** an agreement was announced. This was mostly overlooked in Western coverage of the crisis, as was the fact that the announced agreement was absurd on its face - everybody should have realised it was a sham (the price Russia claimed to be getting and the price Ukraine agreed to "pay" were not compatible, even with the inclusion of ultra cheap gas from Turkmenistan - and nobody asked why Turkmenistan would agree to such a low price).

The hard fact is that Russia cannot cut off Ukraine for any period of time, because that endangers its exports (Kiev has *always* retaliated by siphoning exports), and Gazprom knows it perfectly well. The other hard fact is that, in practice, giving roughly 20% of its gas shipments to Ukraine as payment for transit (over an average of more than 1,000km) is an acceptable transaction for both sides. Of course, when prices for gas go up, as in recent years, the temptation to change the balance of the trade is tempting, but Russia simply has no practical way to do so.

If that is the case, why on earth does Russia play this charade every year - especially now that critical Western eyes are firmly locked on the issue?

I have a simple theory: it's all a distraction from what's really at stake.

3) The real underlying stakes are not about Russia or Ukraine

The leadership of Gazprom has long ago understood that it could not get any money out of official deliveries to Ukraine. It "solved" that problem in a completely different way, by privatising a portion of the gas trade to Ukraine - the portion going to customers able to pay for their gas. These customers used to pay the central Ukrainian gas company, which did not pass on that money to Gazprom. What was put into place was a mechanism whereby these customers would pay less for their gas, but would pay another supplier directly, formally unrelated to either Ukrainian gas authorities or Gazprom.

Of course, only gas coming from Russia could be delivered, and it still needed to use Ukraine's gas infrastructure, so the active cooperation of Gazprom, Russian and Ukrainian senior people was required to put that Trade in place (you can't move 30 billion cubic meters of gas per year without the approval of senior management, and cover from senior politicians) - but the very real money generated did not need to go either to Kiev or to Moscow. Thus the top people that enable that Trade are able to personally benefit massively from it - and effectively cut out both Kiev and Gazprom. (I have described this Trade in a long article for French think tank IFRI here: [Gazprom as a Predictable Partner. Another Reading of the Russian-Ukrainian and Russian-Belarusian Energy Crises](#).)

Now, such a juicy business attracts others keen to get in on the action. In Ukraine, political infighting can largely be understood, in my view, by the fight over who will be the Ukrainian counterparty to that Trade. (It's no coincidence that Yulia Timoschenko made her fortune in gas trading in the 90s, and that Yanukovich represents some of the largest gas-users from heavy-

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industry in Eastern Ukraine). In Russia, similarly, one has to go beyond the image of a monolithic Kremlin with its faithful Gazprom arm - both are rife with infighting and coalitions within both centers of power that come and go (as an example, just look how the 50% of Gazprom formally owned by the Russian State is split between at least two public bodies controlled by different senior Kremlin insiders).

So while the world is focused on the predictable public brinkmanship between Ukraine and Russia (Russia threatens, Ukraine appears to cave in at the last minute, but really doesn't, Russia cuts gas, Ukraine siphons gas, Russian is indignant, both sides make their case to Europe, Russia restores gas supplies, another meaningless agreement is announced), the real fight over the loot is taking place more discreetly between a few oligarchs in Moscow and Kiev. But nobody is talking about that. Which is the whole purpose of the theater show we are "offered."

Worries about Russia or Gazprom using the "gas weapon" against Europe are misplaced. In their official capacity, both are keenly aware of their absolute dependency on exports to Europe for a huge chunk of the country's income, and on the need for stable, reliable long term relationships to finance the investments needed in gas infrastructure (and they know their clients share that need). They are happy to play power politics with the West's worries as this goes down well with their own domestic audiences, but fundamentally they will not rock the gas boat.

Now, what is a lot more worrisome is that governments in Ukraine and Russia can tolerate--and indeed encourage--such blatant breaches of their authority and such large scale theft of what are effectively public resources. That the highest levels of government in both countries, and major bits of their infrastructure can be instrumentalised in what are disputes between unknown oligarchs only shows how little rule of law and accountability there is in these countries, and how powerless Putin really is when dealing with competing power factions.



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