In their row over gas prices, Russia has no reason to make concessions to Ukraine. There is little to suggest that an end to the conflict is in sight.

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Relations between Russia and Ukraine are at a new low after serious gas shortages in Europe this winter. **Olga Shumylo-Tapiola** *argues that the interests of Ukrainian oligarchs will continue to put pressure on the government to demand lower prices, a demand that Russia is unlikely to acquiesce to. The only long term solution is for Ukraine to do more to reduce its dependence on Russian natural gas.*

Russia and Ukraine are engaged in protracted negotiations over a gas deal originally concluded in 2009 by Russian Prime Minister Vladimir Putin and then Ukrainian Prime Minister Yulia Tymoshenko. Current Ukrainian authorities consider this deal unsustainable for their country and, with the Kremlin seemingly unprepared to make significant revisions, there seems to be no easy solution to the problem.

After taking office in spring 2010, Victor Yanukovych promised to improve Ukraine's relations with Russia, especially in the energy sector. Two years on however, relations are worse than ever. Moscow is frustrated with Yanukovych's pursuit of his own personal and corporate interests. Yanukovych, in turn, is frustrated with Russia's unwillingness to make concessions to him in the name of Slavonic brotherhood.

From his first day in office, Yanukovych wanted to re-negotiate the 2009 gas deal. Three elements of the agreement are problematic for him and his fellow oligarchs: the price Ukraine pays for gas, the volume of Russian gas that Ukraine is obliged to buy on an annual basis, and the fee that Russia pays to use Ukraine's gas transit system (GTS).

Kyiv feels that the first two figures should decrease dramatically, while the third should go up. At almost USD $400 per thousand cubic meters, Ukraine pays one of the highest prices for Russian gas in Europe—especially given its proximity to Russia. In addition, despite being the least efficient energy consumer in Europe, it is unlikely that Kyiv will need the 52 billion cubic meters of gas the agreement with Moscow stipulates in 2012. Moreover, European and Ukrainian experts agree that the transit fees Russia pays to Ukraine are low in comparison to those paid to other transit countries.

Will Russia and Ukraine be able to reach an agreement on a revised gas deal?

Some in Moscow say that an agreement addressing Ukraine's concerns could well be reached. However, it would come at a high price. By granting Russia a twenty-five year lease extension on its Black Sea Fleet base in Crimea, Yanukovych attempted to use the carrot in his negotiations with the Kremlin. Moscow responded with a small discount, knocking $100 off the price per thousand cubic meters of gas.

But this was not enough for Ukraine. Ultimately, Russia will need a far larger carrot—control over Ukraine's GTS or Kyiv's membership in the Customs Union or potentially even the Eurasian Union—to make any meaningful concessions. When "the carrot" failed, Yanukovych resorted to "the stick."

His government publicly blackmailed Moscow by claiming the 2009 gas agreement was illegal, arresting Tymoshenko, and threatening to take Gazprom to the Arbitration Institute of the Stockholm Chamber of Commerce (SCC).

When Moscow still refused to revise the contract, Ukraine opted to unilaterally reduce the contracted volume of gas it would purchase from Russia by nearly 50 per cent. Russia now has three options:

- The Kremlin could accept Ukraine's demand to import less gas;
- It could demand that Ukraine pay the penalties the 2009 contract stipulates; or, as a last resort;
- It could take Ukraine to the SCC.

At present Russia is warning Ukraine that it may take legal action, but has not acted so far. In fact, Moscow is continuing to loan money to Ukraine to pay its bills with Gazprom—Ukraine paid its gas bill in October 2011 with money borrowed from Russia's Gazprombank.The two partners are in a protracted process of negotiations as opposed to a full-blown conflict, which neither side can afford at the moment. As it stands, Russia simply has no reason to make any concessions to Ukraine. It is no secret that Moscow uses the price of gas as a political tool in its immediate neighbourhood. With the leadership of neighbouring countries reluctant to end their addiction to cheap gas, Russia has no reason to stop this practice. Energy relations between Russia and its neighbours will only become more equitable once neighbouring elites instil some transparency in their own energy sectors and stop treating them as their personal fiefdoms.

Moscow, however, needs European support for alternative transit routes, such as South Stream, a pipeline connecting Russia and Bulgaria. Moreover, it would like to take control of Ukraine's GTS without facing accusations of bullying. The Kremlin can therefore ill-afford the bad publicity. But Moscow may still intensify the trade war with Kyiv. Exports of Ukrainian cheese to Russia have already been banned. Other exports, such as confectionery, dairy products, and meats may also be targeted. And, although it is unlikely that Russia will cut gas to Ukraine now, this generosity may not persist after the presidential elections.

The situation in Ukraine is slightly more complicated. The country's leadership desperately needs cheaper gas to satisfy the needs of the oligarchs who support it. With parliamentary elections rapidly approaching, re-election campaigns will rely on the financial support of these businessmen. The Russia-Ukraine gas deal was negotiated by then Prime Minister Yulia Tymoshenko, who is currently the leader of Ukraine's opposition. In October of last year, Tymoshenko was sentenced to seven years in prison following what the majority of European politicians and observers deemed a selective, politically motivated prosecution. Against this background, it is highly unlikely that Ukraine's case against Russia will be treated as purely commercial.

Ukraine may also be forced to default on its financial obligations to Gazprom. The country's coffers are virtually empty. The International Monetary Fund is unlikely to offer any assistance before the government raises domestic gas prices, which is unlikely to happen before the October parliamentary elections. Kyiv could continue borrowing from Gazprombank to cover its bills with Gazprom.

The experience of neighbouring Belarus provides a cautionary tale. President Lukashenka was heavily subsidized by Moscow and even succeeded in ensuring the cheapest gas supply in Europe —$164 per 1000 cubic meters in 2012. But he had to give up full control of the country's pipeline to Russia.

Protracted negotiations between Kyiv and Moscow are therefore likely to continue. The country's leadership and fellow oligarchs benefit the most from Ukraine's transit system, with its underground

storage facilities and access it provides to Ukraine's domestic market. Membership in the Customs Union would effectively lead the president to lose political control over the country as greater control over the country's trade and economic policy are ceded to Moscow. Yanukovych will therefore continue his balancing act, insisting for revisions to the 2009 gas deal, while avoiding moves that might push Russia to escalate.

Ukraine needs to decrease its dependence on Russian gas

Having concluded the gas deal with Russia in 2009, Kyiv had an opportunity to overhaul its energy sector, but, thus far focused on short-term solutions, such as the unsuccessful attempts to revise the gas contract with Russia. One of the clearest examples of Ukraine's underwhelming performance in this area is its membership in the Energy Community. The mission of this organization is to extend the EU's internal energy market to southeast Europe and ultimately to ensure the security of the supply in wider Europe. In 2010, Ukraine committed to implementing the relevant EU directives and regulations in the sphere of gas, electricity, and renewable energy resources.

According to a group of independent Ukrainian energy analysts, however, the country has not fully implemented a single obligation. Experts suggest that the Ukrainian authorities saw membership in the Energy Community as a safeguard against the South Stream project and a source of additional financial support from the EU. For its part, the EU hoped that Ukraine's commitment and extra funding would finally push Ukraine to reform its energy sector. Mutual disappointment is growing.

Ukraine feels that the EU is not being supportive in the country's talks with Russia, and that this can be attributed to Moscow's warm relations with some EU member states. However, the EU is simply reluctant to become embroiled in escalating tensions between Kyiv and Moscow. The EU, in turn, feels frustrated by the lack of reform in Kyiv, and now has little reason to support Ukraine in this battle. Failure to implement the Energy Community Treaty obligations was merely one incident in a negative trend in Ukraine that is sending a clear signal to the EU: the country's leadership is not interested in further integration with the Union.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics

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