



## Some predictions on the forthcoming Russian-Ukrainian gas 'crisis'

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We've recently heard more [veiled threats from Putin](#) about Ukraine being unable to pay for gas (thus presumably leading to new attempts at cutting them off), which suggests that Russia is getting itself ready to start a new crisis. That means two things:

1. the internal infighting between groups of powerful Russian and Ukrainian oligarchs for the control of unofficial Russian gas deliveries to Ukraine (more on this below) is still not conclusively settled, and requires "action" using official levers of State and interference with Gazprom's export deliveries through Ukraine;
2. Russia thinks it stands a better chance to focus European blame on Ukraine and, even more importantly, to get Europeans to buy off the Ukrainians (thereby increasing the available unofficial gas loot for the players involved).

While Russia's actions are not easily understandable when considered as those of a country, they are much easier to interpret rationally when you look at who the actual players behind the scenes are. Conversely, public European reactions which sound logical are, in fact, incredibly naive if you know the industry a bit and, given that the people involved are certainly not naive, they are other things at stake.

So let's try to make some predictions and unravel what's actually going on.

*Originally posted on [European Tribune](#). See also my full series of articles on earlier episodes of the Russian-Ukrainian crises [here](#)*

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First, as a reminder, since 1994, there have been two separate bits in the Russian-Ukrainian gas trade:

- the official part, whereby Gazprom delivers gas to Naftogaz (roughly 20-25bcm/y), the Ukrainian national gas company, and uses Naftogaz's network of pipelines for its gas exports to Europe (including Turkey) - roughly 130-150bcm/y of transit; this trade roughly balances itself out, ie is settled without any ash payments. Given that gas prices are more volatile than transit prices, Gazprom regularly tries to get paid something more for the gas it delivers, arguing that it has become worth more than the transit services, and Ukraine refuses to (or can't) pay. This is the public dispute, and it is, in reality, a sideshow;
- the unofficial part, whereby semi-mysterious traders like [RosUkrEnergo](#) and its predecessors deliver gas to Ukrainian clients using Gazprom's pipelines but gas formally sourced elsewhere. As I have explained in detail in [this paper for the IFRI research institute](#), this business was created by Gazprom managers, jointly with large Ukrainian gas consumers, to get around the impossibility for Gazprom to get paid by Naftogaz under the

official trade: Ukrainian gas users get gas cheaper than if they bought it from Naftogas, and the suppliers get some money from gas deliveries from Gazprom's network to Ukraine; the initial customers can then on-sell more gas to other Ukrainian users and make additional money for them and their Russian accomplices. This is fundamentally an unstable business because (i) it has to be done in the shadows, as it goes directly against the interests of Naftogas, the national company, and it uses Gazprom's network at no benefit for the company, (ii) all the major Ukrainian gas users (mainly the big steel-bashing companies in the East) want to be the privileged intermediary that gets first access to the gas and a cut on further sales, (iii) various clans within Gazprom (and their associates in the Kremlin) want their hands on that juicy business. Amongst unavoidable players in this game, you thus have the big customers in Ukraine, the people with formal authority over gas transit both in Ukraine and in Russia, the people with access to gas inside Russia or in Central Asia, and their counterparts within Gazprom...

Fights on the second front can spill on the first front, as the two businesses largely use the same pipelines and gas inside the system is fully fungible.

The West's error has been to try to interpret what's going on in light purely of the first, public, conflict. Of course, one reason this happened was that in 2006, some players in the West had very strong motivations to suddenly make a big deal of what had been a recurring, and mostly ignored, conflict. The UK government was facing the very real prospects of gas cuts as domestic production was shrinking and inadequate plans for import and gas storage were in place; the Russian-Ukrainian gas crisis offered a perfect opportunity to turn a domestic policy failure into an international conflict, with blame nicely thrown at a familiar enemy. In parallel, the US administration had cooled on Putin following the takeover of the Russian oil industry by oligarchs unfriendly to the Western majors which he oversaw; that crisis was a perfect opportunity to paint him as a dictator bent on oppressing his neighbors, especially in the wake of the "colour" revolutions in Ukraine or Georgia. Once that interpretation was pushed onto an unsuspecting public, it took hold - and the Russians, focused on the behind-the-scenes conflict, did little to behave in ways that could have changed that perceptions.

That interpretation of the conflict also had the added benefit of make the US and UK look like the defenders of freedom and markets in Europe, against the weak and compromising French, German and Italians, too cowardly or corrupt to confront the Russians, and too busy coddling their national energy companies against from the "fair competition" of more nimble markets which would otherwise spontaneously create alternatives to Russian gas imports.

By 2009, it was obvious that things were not completely black and white, and the narrative of Russia imperialistically exercising the "energy weapon" against the plucky freedom-loving Ukrainians and other neighbors was not enough to explain things. Europeans, collectively, started taking a harder look at Ukraine's behavior - but they continued to focus almost exclusively on the first conflict, which was much easier to grasp. Russia decided to push its advantage, to push the blame on official Ukraine, and hopefully get Europe to finally pay them something for the gas delivered to Ukraine - thus the much longer cuts that took place in January, and what appeared to be a successful resolution through [European loans to Ukraine](#). But of course, as I [predicted](#) then, Ukraine [failed to meet the conditions to get that loan](#) (which, contrary to the loans extracted from Russia, they'd actually have to repay), dumping the problem once again in Russia's lap.

Fundamentally, even with the new pipelines Russia is building, Ukraine has a stranglehold over Russia's exports, and can go on not paying for its official gas deliveries, effectively offsetting these with the transit service; and it should be noted that, even with variable prices for natural gas, this is not a bad deal for Gazprom (which know it). So while there is a lot of theater around the first conflict, and continued attempts to change the stable solution that has been reached, this is not an equilibrium likely to change, unless Russians and Ukrainians (which have a common interest there) somehow manage to make the European cough up some money along the way. Thus the

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continues crises, and the fearmongering about Russia's "energy weapon," which is basically encouraged by Russia to some extent as it seems to give them a bit more leverage and importance in the public eye.

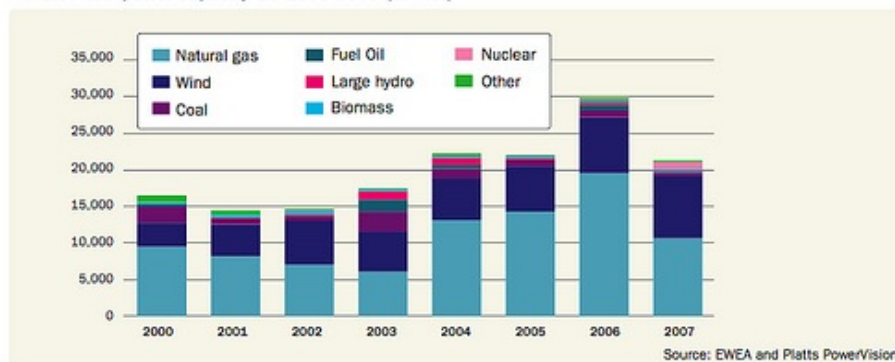
The second conflict is much more intractable, much less subject to the restrictions of traditional diplomacy, and its players are likely to continue to use and abuse the instruments of State they control for their private purposes, thereby creating confusion for international onlookers.

So it is likely that further crises will erupt, and that gas deliveries to Europe will be temporarily shut down, typically in January.

Before going into predictions, an aside: gas consumption is very seasonal, with winter consumption typically double or triple summer levels, which means that quite a bit of storage capacity is needed to smooth out deliveries and ensure adequate supplies through the winter (deliveries in winter are often lower than demand). Most consumer countries - and in particular big importing countries - have significant buffers, and these are usually full at the beginning of the winter, ie when the crises happen. So, other than for a very small number of East European countries that have little storage and fully depend on Russian deliveries, Russian gas cuts have **no impact whatsoever on actual gas availability** for consumers in most countries, which can simply draw on their stored reserves a bit more than usual.

As a final point of background, and as I have argued many times before, electricity market deregulation in Europe has encouraged investment by players in gas-fired power plants, because they are the easiest and least risky to finance (given that electricity prices are largely driven by gas prices, as gas-fired plants are the marginal cost suppliers most of the time, gas-fired plants are almost always going to be in the market, or near enough, to be viable, as opposed to plants with high fixed costs like nuclear or wind which, unless they benefit from specific regulation, can find themselves making short term losses for longer than investors can afford, even if their long term average price is competitive). Over the past 10 years, Europe has built only two kinds of power plants: wind farms, thanks to the specific renewable energy rules, and gas-fired plants:

FIG 1.6: New power capacity EU 2000-2007 (In MW)



So, if one is worried about the gas supplies from Russia, there are two very simple steps fully under our control:

- change power market regulation to eliminate its proven bias towards gas-fired power plants and limit the growth of European demand for gas, a large portion of which, in the long run, can only be supplied by Russia; pointing a finger at Russia's supposed "energy weapon" when one could very easily be less dependent on gas is a sign of incompetence or a distraction from the other priorities of such energy policies (which are, in fact, a jobs programme for City commodity traders, M&A advisors and associated parasites);
- for countries that do not have sufficient gas storage capacity, urgently work on building these, or getting permanent access to friendly neighboring countries that may have more

favorable locations available; lack of storage capacity may have been a valid excuse 15 years ago for many former Soviet Bloc countries which had built infrastructure predicated on Soviet deliveries, but today it should not wash - and blaming Russia for gas delivery cuts is, again, a distraction from incompetent domestic policies.

So, finally, my predictions:

- there will be another gas crisis this winter as Russia senses European worries and tries to get the EU to send some money in Ukraine's way, for Russia's benefit;
- Europe will, once again, ignore the real issue (that Ukraine and Russia have willfully created a parallel gas market, and that their politicians are more busy trying to grab a slice of the loot than to enact sensible energy policies, and will repeat the same tired angry platitudes about the need for Russia (and possibly Ukraine) to behave, and for Europe to be "unified" against this threat (the separate negotiations run by GdF, E.On and Snam will be called inefficient, when they are nothing but; the fact that all of Russia's pipelines go to Europe and they have no choice where to sell their gas will be under-emphasised; the very real protection brought by long term take-or-pay will be ignored - or even [undermined](#))
- there will be yet more calls for a better European gas market, for further energy deregulation (ignoring that this encourages gas consumption), and for a joint purchasing authority (see [here for a recent exemple](#) from a French politician who should know better), without any discussion of how that gas should be split, who should get the presumed (but imaginary, given that current price formulas are already market based) cost savings wrung out of Russia, and who will decide on allocation of shortages, if any;
- expect shortages to appear again in selected East European countries (ie , in some cases, to be manufactured by local authorities in order to blame Russia), without any discussion of the reality of storage and the lack thereof, and conversely, dark accusations (augmented by London and Washington) about the insufficient lack of solidarity of Western Europe and its cowardice towards Russia, with associated calls for further European subsidies to build new connecting infrastructure (a not completely unreasonable idea) or new nuclear or coal-fired power plants;
- Russia will play its accustomed role with its usual rigidity, alternating dark threats, accusations of unfairness from Europe, and shameless calls for Europe to pony up money; it will certainly not offer to sell its gas at Ukraine's border, which would dump the transit problem in Europe's hands, but eliminate the possibility of the second market to exist (Europe will not try to offer the same, as nobody is keen to take over Ukraine's gas infrastructure and its associated problems (underinvestment, corrupt managers at all levels, and a legacy of complex contracts to untangle));
- Ukraine will be, as usual, completely confused, given that the 3 political forces that are fighting it out in Kiev de facto represent 3 of the oligarchic clans that are fighting for the loot. They WILL cut off Europe if Russia reduces deliveries, but otherwise, beyond expecting to get money from the outside, will do nothing to solve the issue or clarify it;
- in the end, the crisis will come and go with no actual impact on the ground (other than temporary or manufactured ones in select countries), politicians and pundits will huff and puff and pontificate importantly, and will provide no actual solution, because none is needed for the important things (Europe does get all the Russian gas it wants), and none is available for the real loot-capture underneath, which is only to the detriment of Russian and Ukrainian citizens, but who cares about them?



