

# CRS Report for Congress

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## Russia's Cutoff of Natural Gas to Ukraine: Context and Implications

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### Summary

This report examines issues surrounding Russia's request for higher prices for natural gas that it exports to Ukraine, which culminated in Russia's temporary cutoff of supplies to Ukraine in January 2006. Implications for the two countries and for U.S. interests are explored. The report may be updated as events warrant. Related products include CRS Report RL32845, *Ukraine's Orange Revolution and U.S. Policy*, by Steven Woehrel; and CRS Issue Brief IB92089, *Russia*, by Stuart D. Goldman.

### Background: Russian Energy and Pipelines

Russia is a major player in world energy markets. In 2004, its 1,700 trillion cubic feet (tcf) of natural gas reserves were the largest of any country; they are 74% greater than those of Iran, holder of the next largest reserves. Russia also is the world's largest gas producer, the world's largest gas exporter, and the second largest oil exporter. Energy exports have been a major driver of Russia's economic growth in recent years, making the Russian economy vulnerable to energy price fluctuations. The natural gas sector, however, is impaired by ageing fields, near total domination by Gazprom (the state-run gas monopoly), government regulation, and inadequate export pipelines, which are operated by Gazprom. Thus, Russia's gas production has risen only modestly since the late 1990s. This limitation and a law requiring Gazprom to supply the gas used to heat and power Russia's domestic market at below-market prices, provide Gazprom a strong incentive to export and to increase the prices it charges foreign customers. Exports have been increasing; Russian gas now provides about one-fourth of the gas consumed by Europe; and two-thirds of Gazprom's revenue comes from sales to Europe, where gas is sold at much higher prices than in Russia. President Vladimir Putin has hailed these exports as the central means by which Russia will reclaim its status as a world superpower, which it lost when the Soviet Union collapsed in 1991.

The Ukrainian gas pipeline system plays a large role as an intermediary connecting Russia with growing European markets, and Ukraine itself is an importer of Russian gas.

In the past few years, however, Turkmenistan has become Ukraine's largest source of natural gas imports. More than 90% of Ukraine's natural gas imports are re-exported to world markets. About 3,800 billion cubic feet (bcf) of Russian and Turkmen natural gas transited Ukraine en route to Europe in 2004. This represented roughly 30% of OECD Europe's natural gas imports and 80% of Russia's natural gas exports.<sup>1</sup> In 2004, piped Russian gas accounted for 72% of Hungary's gas consumption, 44% of Germany's, 29% of Italy's, and 26% of France's.

**Gas and Ukrainian Politics.** Not only have Russia's natural gas supplies to Ukraine and the transit of Russian gas through Ukraine to Europe been key to Ukraine's economy, but some Ukrainian officials and others have long had profitable ties with Gazprom and Russian officials. In Ukraine, these ties have resulted in vast fortunes being made and political power for a few. One former Ukrainian energy official, Yuliya Tymoshenko, emerged as a key figure in the opposition to President Leonid Kuchma after he dismissed her from the government in 2001. The Orange Revolution in Ukraine in 2004 resulted in the ouster of the pro-Russian leadership and the election of the reformist and pro-Western Viktor Yushchenko as president. He appointed Tymoshenko as Prime Minister, who vowed to fight corruption in Ukraine's energy sector. Infighting within the governing coalition between Tymoshenko's supporters and business leaders close to Yushchenko, including over Tymoshenko's investigations of the gas industry, led Yushchenko to dismiss her in September 2005.

## The January 2006 Russian Gas Cutoff

Gazprom reportedly began talks with Ukraine in early 2005 on increasing the price of gas. Ukraine resisted, arguing that an existing agreement guaranteed a low price (\$50 per thousand cubic meters or tcm) until 2009. Gazprom in mid-2005 requested a price rise to \$160 per tcm, but in late 2005 requested \$230 per tcm.<sup>2</sup> President Putin in late December stated that Russia's "fraternal ties" with Ukraine dictated his open intervention, and he offered a loan to Ukraine to help it pay for the higher priced gas. When Ukraine rejected this proposal, Russian state television showed Putin and Gazprom head Aleksey Miller (one of Putin's long-time associates) agreeing on December 31 to cut off supplies to Ukraine. Ukraine compensated by using some gas that Gazprom intended for European customers, prompting Gazprom to accuse Ukraine of "stealing" and of being an unreliable transit country. Ukraine argued variously that it was continuing a long-time arrangement of taking gas as a transit fee in lieu of cash or that it was taking delivery of gas provided by Turkmenistan. The shortfall in gas reaching European customers prompted their immediate protests, and Gazprom restored pipeline flows on January 2, 2006.

The Russian government and Gazprom on January 4 hurriedly reached an interim agreement with Ukraine on a complicated formula for ensuring gas supplies to Ukraine until April 2006. The agreement calls for gas to be purchased by Ukraine through an

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<sup>1</sup> Energy Information Administration. *Ukraine Country Analysis Brief*, January 2005.

<sup>2</sup> Gazprom also requested higher gas payments from Armenia, Georgia, and Moldova. While Russia's foreign minister pointed to the request to pro-Russian Armenia as evidence that political motives were not involved, Putin had stressed that it is "one thing ... to subsidize our neighbors and friends ... and another thing ... to subsidize, let us say, shady business in Ukraine." *FBIS*, December 29, 2005, Doc. No. CEP-27141; February 5, 2006, Doc. No. CEP-27048.

intermediary firm, RosUkrEnergo. This firm pays for gas from Central Asia at a lower price and from Russia at a higher price, and provides it to Ukraine at an average price of \$95 per tcm.<sup>3</sup> The agreement also provides for higher transit fee payments to Ukraine (in cash rather than in gas). Perhaps more troubling for Ukraine, the accord calls for the creation of a joint venture between RosUkrEnergo and the Ukrainian gas firm Naftogaz that grants the former one-half of Ukraine's domestic market. Putin hailed the agreement as establishing "actual market relations" and as guaranteeing "stable conditions for delivering Russian fuel to our European partners for years to come."<sup>4</sup>

## Implications for Russia and Ukraine

**Russia.** The gas cutoff has highlighted for many observers the intertwined relations between Gazprom and the Russian government, and the use of Gazprom as an instrument of foreign policy. Some observers have placed credence in Gazprom's argument that because most of its other foreign customers paid more for gas, the previous gas payments by Ukraine were below the "market rate." Other observers have discounted Gazprom's assertion that the gas cutoff was necessary or appropriate to convince Ukraine to pay more. They have argued that Gazprom's actions were driven less by business motives than by the strategic goals of the increasingly authoritarian Putin government. These include, according to this argument, punishing Ukraine for democratizing and moving toward the West, gaining control over transit pipelines to Europe, and being accorded neo-superpower status.<sup>5</sup>

Whether Russia is succeeding in any of these goals will depend on the outcome of the planned March 2006 legislative election in Ukraine (see below) and other developments. Gazprom seemed unsuccessful in gaining control over transit pipelines in Ukraine, although it appeared to gain greater influence over gas sales to domestic customers in Ukraine. Some observers have dismissed assertions by Putin and others that Russia is becoming an economic and political superpower. They have argued that economies like Russia's — where the energy sector is the main engine of growth — are economically fragile and that such countries have not been central players in international politics. While many European and Soviet successor states that purchase Russian gas may be vulnerable to Russian pressure in the near term, Russia's economic growth could suffer in the long term if the states diversify their suppliers. If it comes to a choice, some believe that Europe will diversify suppliers and take other measures before abandoning a policy of urging democracy and human rights in Russia and Central Asia.<sup>6</sup>

Some observers have argued that Russia's gas cutoff was less the result of rational business decisions or strategic objectives and more the result of infighting among corrupt politicians and criminal elements in both Russia and Ukraine. They question the role that RosUkrEnergo plays in delivering gas to Ukraine, and its non-transparent ownership and

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<sup>3</sup> Many observers have raised concerns about the ownership and operations of RosUkrEnergo. Formed in 2004, one-half of its shares are owned by Gazprom. Other undisclosed shareholders allegedly include Russian and Ukrainian government officials and organized crime elements.

<sup>4</sup> *Rossiia Television*, January 4, 2006. A Russia-Ukraine agreement was signed on February 2, 2006, establishing the joint venture.

<sup>5</sup> Mary Dejevsky, *The Independent* (UK), January 3, 2006.

<sup>6</sup> Alexander Motyl, *Ukraine vs. Russia*, January 17, 2006.

finances. These critics have raised concerns about whether Russia will become less reliable as an energy supplier and a higher risk for foreign energy investments.<sup>7</sup>

**Ukraine.** The Russia-Ukraine gas cutoff and subsequent agreement may have a significant impact on Ukraine's economy and political situation. Ukraine is one of the most energy-inefficient countries in the world. Ukraine's key export industries, especially iron and steel production, are heavily dependent on cheap energy. Higher prices could be the incentive for Ukraine to finally follow through on efforts to improve energy efficiency and to seek alternative sources of supply.

Ukraine's control of pipelines from Russia to Western European markets has long been balanced by Ukraine's dependence on Russian energy. As occurred during the January 2006 gas crisis, Russian efforts to impose higher prices can be countered by Ukraine imposing higher transit tariffs or even by diverting gas earmarked for Europe. However, Russia plans to build a pipeline under the Baltic Sea to Germany by 2010 that would bypass Ukraine and could remove Ukraine's leverage. Yushchenko has acknowledged that Ukraine must eventually pay market prices for gas, but has insisted that the increases occur gradually to permit the economy time to adjust.

The gas crisis came as Ukraine was gearing up for March 2006 legislative elections. These elections are likely to be key to Ukraine's domestic reforms and geopolitical orientation. In recent opinion polls in Ukraine, the Party of Regions, headed by the pro-Russian former Prime Minister Viktor Yanukovich, is the most popular single party in Ukraine. Yanukovich has said that the gas crisis shows the need for Ukraine to join a "common economic space" with Russia. This stance plays to strong sentiment in the eastern Ukrainian powerbase of the Party of Regions for closer ties to Russia. It also serves the purposes of eastern Ukrainian businessmen who are the main backers of the Party of Regions. These businessmen, although not eager to subordinate their personal interests to those of Russia, nevertheless depend on Russia for the cheap energy needed to power the steel and other energy-intensive industries that they control.<sup>8</sup>

The gas cutoff has also dealt a blow to the credibility of the current Ukrainian government, led by Yushchenko's Our Ukraine bloc. The agreement was criticized by Tymoshenko and other observers on several grounds, including the dubious reputation of RosUkrEnergo. Critics (and, more importantly, RosUkrEnergo officials) said that the agreement provided no guarantees that the gas price will remain fixed at \$95 per tcm for five years. If this is true, Russia would therefore appear to be free to instigate another crisis in the future, perhaps when temperatures in Ukraine drop in late 2006. Objections to the gas deal caused the Ukrainian parliament to adopt a vote of no confidence in the government in January 2006. Yushchenko has maintained that the vote was illegal and has refused to dismiss the government.

Nevertheless, the impact of the crisis on the outcome of the legislative election is unclear. Public opinion polls have shown that support for the main political groups in Ukraine has not changed substantially since the gas crisis. If Yushchenko is perceived

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<sup>7</sup> *Financial Times*, January 25, 2006; Igor Torbakov, *Eurasia Daily Monitor*, January 6, 2006; Peter Rutland and Donald Jensen, quoted in Peter Lavelle, *Russia Profile*, January 13, 2006.

<sup>8</sup> *FBIS*, February 6, 2006, Doc. No. CEP-27227; February 7, 2006, Doc. No. CEP-27008.

to have bungled the gas crisis, it may further demoralize his supporters, depressing turnout in western Ukraine. On the other hand, Russia's perceived bullying of Ukraine could help Yushchenko or other parties not closely associated with Moscow.

Analysts have noted that, in the wake of the gas crisis, Putin has appeared more conciliatory toward Yushchenko. They believe that this may reflect a Kremlin preference to handle Russian-Ukrainian relations informally at the highest level, a pattern adopted by the presidents of both countries since Ukraine's independence in 1991. However, Yushchenko's avowed pro-Western orientation and reluctance to join a "common economic space" or other political or economic union with Russia may have required that he be "softened up" by the use of the "gas weapon," according to these observers. By such a strategy, Putin may be hoping to secure foreign policy or economic concessions from Yushchenko, particularly if the Party of Regions becomes the strongest party in Ukraine after the March election. It is possible that Putin hopes that a weakened Ukraine will enter a coalition government with the Party of Regions rather than with Tymoshenko, who would likely continue to question the gas deal.<sup>9</sup> Putin may also hope to achieve Russia's goal of ownership of Ukraine's pipelines and storage facilities.

However, such Russian objectives may be hard to achieve, even with the use of the "gas weapon." Most observers believe that it is unlikely that Yushchenko will change his pro-Western views. Moreover, even under the previous incumbent, the pro-Russian President Kuchma, Ukrainian leaders pursued a policy of appearing to promise Russia more than they could or would deliver, both in foreign policy and in control over gas infrastructure in Ukraine, in order to secure cheap energy while preserving assets key to Ukraine's independence. However, this temporizing Ukrainian strategy may have hit a dead end with Putin's more business-like approach to the gas issue, forcing Ukraine either into Russia's political orbit, or casting it out into a closer relationship to the West.

## Implications for U.S. Interests

The Russia-Ukraine gas dispute has raised concerns about Russia's domestic and foreign affairs, Ukraine's sovereignty, and issues of U.S. and international energy security. The Administration appeared to take a cautious approach toward the Russia-Ukraine dispute over gas pricing, but responded forcefully to the January 1 cutoff. In common with European governments, the United States emphasized Russia's culpability. State Department spokesman Sean McCormack criticized Russia for using "energy for political purposes," and for acting while Europe was in the midst of an extreme cold spell. He stressed that while the Administration supported a gradual increase in prices to market levels, it disagreed with a "precipitous" increase and cutoff. Secretary of State Condoleezza Rice likewise on January 5 stated that Russia had not appeared to be a "responsible actor in the international economy" by making "politically motivated efforts to constrain energy supply to Ukraine." She warned that such efforts also raised concerns about Russia's suitability for the 2006 chairmanship of the G-8.<sup>10</sup>

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<sup>9</sup> *Eurasian Daily Monitor*, February 3, 2006.

<sup>10</sup> The State Department. *Statement*, January 1, 2006; *Daily Press Briefing*, January 3, 2006; Secretary Condoleezza Rice, *Remarks at the State Department Correspondents Association's Breakfast*, January 5, 2006. She later urged continued engagement. *Interview With Bob Schieffer* (continued...)

Some observers argue that U.S. concerns about the gas cutoff should not interfere with higher priority U.S.-Russian cooperation in combating terrorism or addressing such issues as nuclear proliferation in Iran and North Korea.<sup>11</sup> Others suggest that the cutoff is emblematic of rising Russian neo-imperialism, which threatens energy security and sovereignty in the Soviet successor states and the wider Euro-Atlantic region. Some of these observers warn that the West is again faced with containing Russia.<sup>12</sup>

The Russian gas cutoff may increase U.S. government concerns about energy security, including the diversity of liquefied natural gas (LNG) suppliers. In testimony on February 2, 2006, John Negroponte, the Director of National Intelligence, warned that the gas cutoff was “an example of how energy can be used [by Russia] as both a political and economic tool,” and that such actions by key producer states and others “pose significant U.S. national security risks or foreign policy challenges.”<sup>13</sup> Deputy Assistant Secretary of State Matthew Bryza appeared to reflect such concerns during a mid-January 2006 visit with Turkmen President Saparmurad Niyazov. Reportedly, the two sides discussed cooperation on developing and exporting Turkmen energy resources, in order to “enhance competition on European markets.” The visit also may have reflected greater U.S. advocacy of multiple oil and gas pipeline routes in the Caspian Sea region, including those that do not traverse Russia or Iran. The gas cutoff may affect decisions by U.S. firms about investing in the Russian LNG industry for future imports.<sup>14</sup>

European governments became increasingly concerned about energy security issues after the gas cutoff. European Union (EU) energy ministers plan to meet in March 2006 to discuss cooperation and the development of alternative energy sources and transit routes. On February 9, European Commission President Jose Manuel Barroso urged Euro-Atlantic cooperation on energy supplies, and Polish Prime Minister Kazimierz Marcinkiewicz the next day called for the EU or NATO to formulate a “Euro-Atlantic Energy Security Pact” to protect against coercion by gas and oil suppliers.<sup>15</sup>

The gas cutoff has heightened concerns among some in Congress that U.S.-Russian cooperation on counter-terrorism and other strategic issues is threatened, and that Russia is failing to democratize, respect the independence of fellow Soviet successor states, and meet other conditions of U.S. assistance. The cutoff may also strengthen views among some Members that Russia is not a suitable host for a planned July 2006 G-8 (group of eight industrial democracies) summit in Moscow on energy security. Senator John McCain reflected such concerns when he called in early February for the G-8 leaders to boycott the summit, in part because of Russia’s autocratic handling of the gas dispute.<sup>16</sup>

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<sup>10</sup> (...continued)

of CBS’s *Face the Nation*, February 12, 2006.

<sup>11</sup> Dimitri K. Simes, *Los Angeles Times*, January 14, 2006; *Financial Times*, January 6, 2006.

<sup>12</sup> David Satter, *Wall Street Journal*, January 3, 2006; *Financial Times*, January 6, 2006.

<sup>13</sup> U.S. Senate. Select Committee on Intelligence. *Testimony*, February 2, 2006.

<sup>14</sup> *FBIS*, January 14, 2006, Doc. No. CEP-27065; *PBS NewsHour*, January 2, 2006.

<sup>15</sup> *Associated Press*, February 10, 2006.

<sup>16</sup> *Agence France Presse*, February 4, 2006.