

# ***The Future of Natural Gas in Ukraine: implications for Europe's security of gas supply***

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## **Overview**

The ongoing political crisis in Ukraine has once again put the question of security of gas supplies to Europe high on the political agenda (see e.g., the recent Joint Statement of the G7 Rome Energy Ministerial Meeting and various media reports). The paper addresses three questions: (i) Ukraine's role in security of gas supplies to Europe, (ii) the future of gas in Ukraine, and (iii) why Europe should support Ukraine's energy reform agenda. The emerging discussion about Europe's energy security, and primarily Europe's gas security of supply, could be summarised with the following points:

- Russia's assertive policy vis-à-vis Ukraine is equated with its willingness and ability to use energy as a coercive policy against Ukraine (and Europe); therefore, Europe should eradicate its dependency on Russian gas
- In light of this widely popular discourse, Ukraine's dominant position in transit of Russian gas to Europe and its foreign energy policy as well as how Russia has been dealing with this security problem is mooted and overlooked.

We argue that Europe's energy policy response should be to press Ukraine for full and strict reform of its gas sector. This will allow Europe to fulfil two important foreign and energy policy objectives: (i) integrate Ukraine into its single gas market and hence putting Ukraine on the right 'Euro-integration' path, and (ii) 'normalise' gas relations with Russia. In contrast, gaining gas independence from Russia would be counterproductive from both economic as well as EU's foreign and energy policy standpoints.

## **Methodology**

Combination of quantitative and qualitative analysis.

## **Results**

Ukraine has asymmetric economic (and political) interests between cheap gas supplies and its gas transit business and hence security of gas supplies to Europe. Therefore, the solution to the European security of gas supply problem is to remove Ukraine's dominant position in the transit of Russian gas to Europe – one monopoly (Russia) is better than a chain of monopolies (Russia and Ukraine). In this regard, Russia's policy in dealing with the security problem has been to bypass Ukraine at any cost and with the completion of the second 'bypass' pipeline – South Stream – Ukraine would be completely bypassed in just a few years.

Although Europe's support for Russia's bypass pipelines may seem at first counterintuitive with its foreign policy objectives towards Ukraine, this support should encourage Ukraine to reform its gas sector. In fact, Ukraine's integration into Europe lies through the integration of its gas market into the European single gas market. In this regard Ukraine's accession to the European Energy Community (EEC) in 2011 is a good opportunity; however, in its progress report the Secretariat of the EEC stated that Ukraine has made very limited progress regarding its obligation as a member of the community. Given the current crisis and Ukraine's complete dependence on the Western financial support, European authorities should work with Ukraine very closely to ensure that the country has a well-functioning gas market through proper restructuring, deregulation and liberalization of its gas sector.

Importantly Europe should press Ukraine to reform its gas sector, particularly to reform its gas pricing policy by removing subsidies to households and heat producers. By gradually increasing the gas prices for these two consumer groups Ukraine could: (i) reduce its gas import bills substantially, and (ii) improve gas supply security for the country and for Europe. Bringing gas prices for households and heat producers to the parity level of Russian gas import price would allow Ukraine's domestic production to cover consumption for households and district heating, which is the most vulnerable customers. This would remove the security of gas supplies through Ukraine completely because in case of a gas dispute with Russia, Ukraine would not siphon Russian gas transit destined for European customers as this happened in the past.

## Conclusions

Gas pricing reform in Ukraine is Europe's best policy option that would completely improve the security of gas supply through Ukraine at no cost to Europe, Ukraine or Russia. Gas pricing reform should also increase the attractiveness of the Ukrainian gas market and stimulate private investment into exploration and development of Ukraine's gas resources, both conventional and shale gas. Given the benefit of this policy option, Europe should ensure that Ukraine takes the following concrete actions over the next five years:

- Abandon multi-tier pricing system and introduce a single wholesale price for all consumers which would be on par with the import price from Russia
- Increased receipts from the higher gas prices should be directed towards: (i) supporting the most vulnerable, low-income households in Ukraine, (ii) financing energy savings project and particularly those aimed at improving energy efficiency of residential buildings (such as thermal refurbishment), and (iii) funding exploration of gas resources in Ukraine
- Deregulation and liberalization of the utility sector and particularly the heating sector. This is particularly important given huge energy saving potential of the residential sector in Ukraine – deregulation and liberalization of the utility sector would improve efficiency of the sector by encouraging competition as well as reassuring market entry by innovative, flexible service firms who could mediate energy efficiency projects between housing associations and big utility companies.
- Deregulation and complete liberalization of the upstream production sector, as well as transmission and storage sectors
- Implement EU's 3<sup>rd</sup> Energy Package in full
- Ensure that reverse flow from Europe to Ukraine is in place. This will attract market entry into the Ukrainian gas market and hence increasing competition while keeping Russian gas import price in line with the European levels

All in all, supporting and helping Ukraine to reform its gas sector fulfils Europe's two important policy objectives: (i) Ukraine's integration into Europe is through 'Europeanization' of its energy markets, and (ii) helps to improve European energy security and eliminates the gas insecurity of supply syndrome. This policy option is a win-win strategy for Europe and Russia as this would help to reset energy relations between the two parties because improving gas security of supply is a common objective for both Russia and Europe.