The Ukraine crisis: another crossroads on Russia's downward path

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The energy aspects of the crisis in Ukraine are viewed by many western observers in terms of the energy security of European countries whose gas imports might be affected, and the perceived danger that Russia will use its energy resources to enhance its geopolitical position. Such starting points obscure vital questions for both Ukraine and Russia. The most pressing energy security issue – that millions of Ukrainians may face serious shortages of gas, electricity, and heat this winter – is downplayed, along with the long-term advantages that this crisis could produce for Ukraine if it reduces its dependence on imported gas. As for Russia, the obsessive focus on its government's geopolitical aspirations obscures larger issues: that its economic influence over (and energy trade with) Ukraine and other neighbours is declining, its own economy is becoming more and more one-sidedly a supplier of oil, gas, and other raw materials to world markets, and its own development in the broadest sense is suffering as a result.

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For Ukraine, the immediate energy issue is that since 16 June deliveries of Russian gas have stopped, due to unpaid debts – stated by Gazprom as $5.4 billion. For many years, commercial negotiations, however fraught, were usually resolved with the help of parallel political talks. But now there is no meaningful political communication and, consequently, the danger of a lengthy cut-off looms. Ukraine should be able to hobble through the summer, especially if the European Commission comes good on vague promises to help finance refilling gas storage facilities. (About 6 bcm is needed in July–September to reach the normal pre-winter level.) But it cannot get through the winter without Russian gas.

Alternative supply arrangements

Much is made of the potential of 'reverse flow' deliveries from central European countries. But no more than 15 bcm/year of capacity (and probably less) will be available this year, while Ukraine's gas import requirement stands at 30 bcm/year. The gas will still almost all originate from Russia and will need paying for. If supplies stop during the winter, a secondary set of energy-related hardships – including widespread power, heating, and gas cuts and industrial shutdowns – could add to the humanitarian disaster caused by near civil war in eastern Ukraine.

In the longer term, this crisis seems sure to accelerate the decoupling of Ukraine's energy system from Russia's. In the gas trade, where two decades ago Soviet-era internal transfers gave way to commercial relationships underpinned by intergovernmental agreements, a new transition seems inevitable. When Naftogaz's current import contract expires in 2019 – and quite possibly before then – Ukraine is likely to move to a new, market-oriented system, in which the political underpinning is removed, and gas is sold at Ukraine's eastern border to any buyer. The post-Soviet arrangements, under which Gazprom's gas for Europe was transported through Ukraine and sold on contracts at its western border, are also being dismantled: Gazprom is seeking alternative export routes, and both Ukraine and the European Commission want to integrate its transport network and substantial storage capacity with markets further west. Politicians who talk about these changes as potential solutions to this year's crisis are putting the cart before the horse – but they are possible over the longer term, as a result of the crisis.

Prospects for future energy demand

In the course of such a transition, Ukrainian dependence on Russian gas might be reduced not only by 'reverse flow' and sourcing other alternative supplies – although realistically these could only come from increased domestic production – but also by destroying some gas demand altogether through the employment of energy efficiency and conservation measures. Ukrainian specialists have often said that straightforward, economically rational measures could halve the country's gas import requirement within five years. The prospect of progress towards a less inefficient and less wasteful energy system – one that is also less under the control of small political and business interest groups and less dependent on Russian supplies – seems to be not only welcome but also a fairly likely outcome of the crisis.

From Russia's point of view, the start that has been made in decoupling from the Ukrainian energy system are part of a larger centrifugal trend in energy and the economy. Its ties with other former Soviet states have progressively loosened over a quarter of a century. The mountains of commentary about how the Russian government seeks to use energy resources for political ends – together with the more modest, but still significant, phenomenon of it actually having done so – tend to obscure the fact that energy dependencies based on Soviet-era infrastructure have been reduced, and economic relationships between former Soviet states have

contracted, as each of those states integrates into the international economic system. Ukraine, starting its painful disentangling from gas and gas transit arrangements with Russia, is joining the Baltic states which have also been seeking alternative energy supplies.

Energy supplies from the Caspian and central Asia

In the Caucasus, beginning in 1993 and thanks to both the ACG oil project and the Baku–Ceyhan pipeline that diversified transit via Russia, Azerbaijan developed as a significant oil exporter. From 2007 onwards, it was further transformed from being an importer of Russian gas, to being the supplier of not only its own market, but also of Georgia's and some of Turkey's. The unravelling of energy and economic relationships between Russia and central Asian states has been still more dramatic. China has replaced Russia as central Asia's most significant trading partner (not only in energy), and its most significant destination for hydrocarbons exports. In Kazakhstan, China financed the construction of an oil pipeline for direct exports (commissioned in 2003–5) and has invested heavily in the upstream; western companies have invested in the three major oil projects (Tengiz, Karachaganak, and Kashagan); Russian companies trail far behind in terms of investment and off-take. The completion in 2009 of the Central Asia–China gas pipeline means that most of Turkmenistan's substantial, and rising, gas output will be exported for two decades (and probably for much longer) to China, in quantities that already dwarf its sharply reduced exports to Russia, which no longer needs these supplies.

Russian energy's place in world markets

Russia's own trade pattern, in energy and other sectors, has correspondingly shifted away from other former Soviet states and towards the rest of the world. Its production is increasingly financed via international markets; its largest oil and gas companies (such as Rosneft, Gazprom, and Lukoil), have become international players, able to compete with western-based IOCs. Western politicians may fret about Russia's geopolitical aims, but economists observe its integration into the world market primarily as a supplier of oil, gas, coal, and other raw materials – an unlikely basis for 'great power' status.

The Ukrainian crisis has exposed some of Russia's economic frailties. Its recovery from the 2008 recession has, despite strong oil prices, been extremely sluggish. The economy was doing badly even before the limited sanctions agreed on by the divided western powers, and these may be sufficient to push Russia back into recession this year. The nationalistic jolt given to Russia's political life by the annexation of Crimea is likely to divert public and political attention from such problems, and further postpone discussion of how to reduce Russia's dependence on energy export revenues.

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Ultimately, judgments of the impact of the Ukraine crisis on Russia's energy economy depend on the starting point. In geopolitical terms, this looks like success: Crimea has been annexed; the west has been too divided to react; and Europe's unwillingness to disrupt energy imports has constrained those who want tougher sanctions. But if Russian achievement is measured in terms of its own human or economic development, then this is another episode in a story of decline.

There are many ways to measure development. The Russian government, and many economists, consider that investment in non-energy sectors – to diversify away from reliance on oil and gas – is key. Such diversification has been shown to be fiendishly difficult to achieve, but in Russia's case, lamentably little progress was made during the pre-2008 oil boom when, it is argued, it had the chance. A recent World Bank report (*Diversified Development: Making the Most of Natural Resources in Eurasia*) argues that asking 'how to reverse the trend toward export specialisation and sector concentration' is the wrong question. It argues that infrastructure (such as roads, telecoms, schools, and hospitals, rather than Olympics-related projects), and investment into 'healthier and more skilled people' matter; institutions and governance count; clearer distinctions are needed between windfall gains from high commodity prices and better economic performance. But in these ways, too, progress has disappointed, while both before and after 2008, indicators of resource dependence (such as oil and gas's share of GDP or budget revenues) have risen inexorably. A recent summary of arguments on Russia's economy can be found in the May 2013 edition of *Europe–Asia Studies* ('Russia's Response to Crisis: the paradox of success' by Neil Robinson).

On average, living standards did improve during the boom, partly because of rising state sector wages and pensions. But inequalities of all kinds (between rich and poor, between oil-rich regions and others, in health care and housing) multiplied; Russia's demographic crisis deepened; its brain drain continued unabated; and on climate change, perhaps the longest-term human development issue, it remained stubbornly stuck in the 'do-nothing' camp. In all these respects, the Ukraine crisis is another crossroads on a long-term downward path. These issues, rather than geopolitical ones, deserve more public attention.