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# President Yanukovich's Dubious Deal

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5 May 2010

The newly, democratically elected President Yanukovich of Ukraine has got off to a spectacularly fast but equally dubious start. First on his diplomacy: his first supposedly symbolic act of foreign policy was to fly to Brussels, even before Moscow, as if to demonstrate his European credentials. But after seeing what he did in Moscow a few days later, this day trip to Brussels now looks a very hollow gesture.

In Moscow, he made a two-part deal, described in the headlines as an extension of the lease of the Russian Black Sea fleet at Sevastopol for 25 to 30 years, in exchange for a 10-year discount off the price of gas. As the Russian President has said, these two elements are intimately interconnected.

President Yanukovich has said that the gas discount deal gives Ukraine a profit of $40 billion over the ten-year period, thus around $4 billion per year. According to a Gazprom press release, this savings is made up as follows:

- The price discount will be equal to the reduction in the gas export duty set by Russia (which in principle represents the difference between world market prices and Russian domestic prices).
- This reduction is 'expected' to be cut by $100 per 1,000 cubic metres, and will not exceed 30% of the gas price.
- The discount will apply to 30 billion cubic metres in 2010, and 40 billion cubic metres in 2011 ($100 multiplied by these amounts = $3 to 4 billion).
- The price formula and 'take or pay' principle will remain as originally stipulated (implicitly as in the agreement of 19 January 2009, which has been widely reproduced by the media). The 'take or pay' principle obliges the gas importer to pay for a given quantity of gas, whether he takes it all or not.

This deal has three aspects, all of fundamental importance for the future of Ukraine – the political, the strategic and the economic – and all of which can be seriously criticised.

The political disaster for Ukraine is that Yanukovich has converted a relatively correct democratic electoral win into the most egregious case of 'state capture'. This is a term of art of political analysts, who describe a party coming to power as treating their electoral victory as a license to appropriate and distribute state assets for the private benefit of its leadership and supporters. What has been common in the new, post-communist democracies of Eastern Europe is the rigging of privatisation processes in favour of the party in power. But Yanukovich takes this black art to new heights, in selling out the strategic Sevastopol naval base in exchange for cash benefits for his oligarchic friends and supporters in the gas-trading and gas-consuming sectors.

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President Yanukovich has described the renewal of the Black Sea Fleet lease as improving European security. That of course depends entirely on how Russia will frame its security strategy in the Black Sea region, and use the naval base in the future accordingly. We cannot predict the future, but we can observe recent realities, notably Russian strategic behaviour that led to the August 2008 war. This was an episode in which Russia's sustained provocation delivered the pretext to invade Georgia, leading on to its recognition of the independence of Abkhazia and South Ossetia.

Finally, we come to the economics of the gas price deal, which are not transparent. What is the reference price in relation to which the 30% cut is given? It is not at all clear. What has been happening recently to world gas market, affecting the difference between Russian domestic and international prices? Again it is not precisely clear, but some fundamental trends suggest that this 30% gift may become in some degree at least a deceptive illusion. International gas prices have certainly been substantially eroded in the last year under three influences, weak demand resulting from the economic slump, but also increasing supplies coming from shale gas in the US, and liquified natural gas (LNG) supplies from diverse sources such as Qatar, Australia, Nigeria and elsewhere. Whereas pot oil prices have risen from $50 to $80/barrel since the beginning of 2009, spot gas prices have not followed suit. Only the first of these three factors is temporary, and the other two are permanent. In particular for Europe there is now an abundance of LNG supplies, as the US has become self-sufficient in gas. As a result, Gazprom had in February 2010 to concede to E.ON and ENI a large crack in the price-setting mechanism, which consisted of indexation on the oil price lagged by around 6 months. These major European importers have themselves secured significant quantities at 'discount' prices linked to the spot market for gas, leaving other volumes subject to the 'official' oil-linked price. Which of these prices is the reference for Ukraine's discounted price? Maybe Ukraine's 30% discount price is not so different from the discount that E.ON and ENI have obtained, without giving a naval base in exchange. Moreover the structural changes to the world gas market may mean that the present 'temporary' break in the oil-gas price linkage may become permanent, alongside a relative decline in the world market price for gas, and given the massive expansion of LNG supplies to Europe leads to the emergence of a significant spot market in Europe. So even Ukraine's 30% discount and annual $4 billion benefit is in some degree being eroded.

This weakness in the gas deal is magnified by the divergence between the time horizons for the gas price and Sevastopol deals, 10 years for the former versus 25 or 30 years for the latter. If the gas discount is meant to be a quid pro quo for Sevastopol, the time horizons should logically have been the same.

In addition Ukraine itself may have large potential for shale gas. This has already become apparent in Poland. If these domestic or foreign alternative supplies develop, Ukraine's agreement to 'take or pay' huge quantities of gas is especially hazardous.

Who will get the benefit from the discount, to the extent it is real? Given the opaque nature of the gas trade, especially in and through Ukraine, there will be opportunities to win arbitrage profits between the discounted import price and the European market prices. All manner of gas swap techniques are at play, and Dmitri Firtash, the Ukrainian oligarch who is a backer of Yanukovich, is a master of this gas swap trade business. Ukrainian gas-consuming industries will also gain, but the Ukrainian economy will remain the most gas-inefficient in the world. So Ukraine will be locking itself into a structure of major financial incentives to maintain, at one and the same time, gas inefficiency and dependence on Russia.

The alternative economic deal, on the basis of a political choice by Ukraine to extend the Black Sea Fleet lease, would have been to maximise the direct rent for the Sevastopol base, and to have put the annual $4 billion (or whatever sum) into the Ukrainian budget for the life of the lease. The gas price could have been left open to negotiation in the light of market tendencies, or left to the previous market price formula: i.e. to take the European import price as reference, and on this basis calculate the Ukrainian 'net-back' price (i.e. discounted for the lower transport costs). The Ukrainian government could then decide how the Sevastopol rent should be used: as a budget deficit reduction, as subsidy to aid energy efficiency or as social assistance where most acutely needed.