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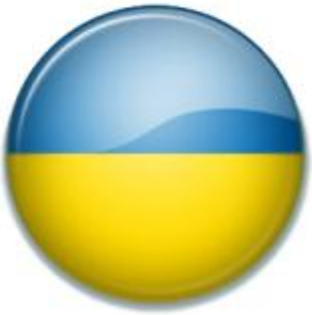
UKRAINE – THE EUROPEAN UNION



KEY THEME ANALYSIS

Russia's new gas threats against Ukraine targeting the EU

Russia is currently observing, with satisfaction, the efficiency of the gas lever usage towards Europe, which allows Moscow to solve issues for its benefit. Significantly, one of the reports of the Center for Political Studies of the Military Institute of the USA and Canada on the Russian Academy of Sciences about "Russia's military policy optimization in order to ensure the national energy security", which was published in November 2012, contains a rather frank statement: *"The main consumers of Russian crude oil are countries in Eastern, Central and Western Europe. Even the countries enjoying relatively diversified economies, such as Germany, are heavily dependant on Russia, which supplies to this country 40% of the total exports of gas and 20% of oil exports. This is one of the factors allowing Russia to achieve certain political goals, such as suspension of NATO enlargement, deepening ties with Ukraine by supporting a pro-Russian candidate in the presidential elections etc."*

Regarding *etceteras*, it can be noted that by achieving a strategic goal of blocking Ukraine's NATO membership, Russia has targeted another triple parallel position - to block Ukraine's European integration, force it to join Putin's Eurasian integration projects and actually negate the efforts of the EU Eastern Partnership and the Energy Community programs. Ukraine has recently rejected persistent proposals regarding the Eurasian Customs Union, but after taking a little pause Russia switched to an active attack again using the gas and pipeline infrastructure factors.

The above mentioned information is important to understand what ideas and mechanisms Russia has in its hands for implementation. The point is simple: the main tool of Eurasian integration is the pipeline and energy infrastructure in general, as a universal means of achieving any economic, political, and other goals. However, this requires that all pipelines in Eurasia are in the same hands. For example, Belarus has already been deprived of its gas mains. No wonder that the controlling stake of all bypass piping is concentrated in the hands of Gazprom. Ukraine is next. It is of extreme importance for Russia because gaining control over Ukraine's GTS will put the entire pipeline infrastructure of the Eastern Corridor gas supply under the control of Gazprom. According to the Kremlin, this will create new quality in Russia's relations with the EU. We believe this idea to be false because the early XXI century European market model is different from the pseudo market of the late XX century.

It is no accident that Gazprom has lost on the EU market in 2012 - 11.2 billion cubic meters (total supply amounting for 112.7 billion cubic meters), though it purchased Norwegian "Statoil" - 13.4 billion cubic meters of additional supplies finally amounting for 107.6 billion cubic meters. Russia's 'gas power' is becoming increasingly elusive, but the inertia of representing Russia with its pipes and gas make it hot for Europe reserves.

Gazprom's 7 billion-dollar claims to Naftogaz are believed to force Ukraine to agree at least on the surrender of its GTS and at most to surrender the GTS along with the country's accession to the EurAsEC and joining the Customs Union. These 7 billion almost coincide with the esttimated but not published numeral value of Ukraine's GTS. This indicates a clear desire of Gazprom to get GTS in exchange for a virtual debt (a stick) and a discount in the price of gas (a carrot), which the company is forced to offer almost all European clients due to a dynamic fall of Gazprom's share in the EU gas supply.

It is crucially important for Ukraine to consider Gazprom's claims entirely in the field of the law. This means that within 30 days Naftogaz and Gazprom would have to negotiate the settlement of the claim as for insufficient minimum annual volume of gas withdrawal under the contract. If the negotiations do not result in working out a mutually acceptable solution, only then will Gazprom, as the author of the claim, get the right to appeal to the Stockholm Court. In this case, Naftogaz will have to define its legal line: either to defend itself and deny (a necessary legal base being present) the validity of Gazprom's claims, or to stick to a more aggressive approach by counterclaim for annulment of paragraph 2.2.5 of the Contract or even the very Contract itself. Moreover, Naftogaz has legal grounds (including those under the governing law of Sweden) to prosecute Gazprom and present a billion-dollar bill for damages due to the considerable reduction of gas transit through Ukraine. This is a claim to the Transit contract that can span the whole time period from January 19, 2009 and is based on the fact that Gazprom, contrary to its contractual obligations, surpasses much less than the minimum of 110 billion cubic meters of gas through the territories of Ukraine annually. Paragraph 3.1. of the Transit contract states that the *"Customer annually passes to the Contractor no less than 110 (one hundred and ten) billion cubic meters of natural gas in order to transit it to European countries during the time period of 2009 to 2019"*. Therefore Naftogaz' 'transit' counterclaims could be consolidated into a single arbitration 'package' along with the claims by Gazprom as for insufficient gas withdrawal.

Given the legal invalidity of Gazprom's bill for 7 billion dollars, Naftogaz' denial to pay this bill should not have resulted in the termination or suspension of gas supply to consumers in Ukraine. Such a sanction is not written in the Contract. If Gazprom, according to its logic and interpretation of the Contract as well as the vision of a 'partnership' relationship with a major buyer of Russian gas, still tries to stop or limit the gas supply to Ukraine regarding the refusal of the latter to pay the 7 billion-dollar bill, such actions can be treated as a gross breach of the Contract; Naftogaz will have the right to terminate the contract unilaterally (due to its substantial violation by Gazprom) and require signing a new contract or consult the Stockholm Court requiring to oblige Gazprom to immediately resume the gas supply to Ukraine as an interim measure. Moreover, this requirement may be tried by an ‘emergency arbitrator’ appointed within 1-2 days. The arbitrator has to pass a mandatory judgment on interim measures in a 5-day period (this option is provided by the Stockholm Arbitration Rules).

However, it seems that Ukraine is not going to take the legal route and prefers traditional methods of backroom gas diplomacy with well-known 2006, 2009 and 2010 negative effects. No wonder the President of Ukraine had publicly taken offence at the Energy Community in Vilnius, that did not help Ukraine in its gas relations with Russia. The Minister of Energy in Kiev had argued that the country does not need any aid from Europe. This is an indication that Kyiv wants to change its ‘offended by Europe’ position and turn its policy towards Russia. And the Kremlin is apparently wishing our country to arrive at the EU-Ukraine summit enjoying the status of a party *de facto* willing to abandon the European integration and *de jure* ready to sign an agreement to transfer control of the GTS into the hands of Gazprom. The fact that Russia is only talking about 50% control and, specifically, for management purposes solely doesn’t calm anybody down. The reality will be different. In order to understand the reality one just has to look at neighboring Belarus.

UKRAINE – NATO

KEY THEME ANALYSIS

At the Munich Security Conference Russia again questioned the priority of NATO in ensuring the European security

The necessity to discuss a number of pressing issues about international peace and security has brought nearly 400 leaders together for the 49th Conference on Security, held in Munich in February 01-03, 2013. The gathering did not manage to reach any results, except for some vague arrangements for the future. Key meetings and discussions took place without participation of a wide range of experts and journalists. Discussion of the burning conflict in Mali appeared to be just superficial. The situation was caused by the fact that the two top speakers from France, the country responsible for conducting military operations in this African country, did not come to Munich. Both speakers, the country's Defense Minister Jean-Yves Le Drian and the Foreign Minister Laurent Fabius, were escorting the French leader Francois Hollande during his trip to Mali at the time.

General discussion took place against the background of heightening tension between Russia and the United States, the key participants of the summit, which was caused by the approval of the Magnitsky Act, the Dima Yakovlev Bill, Russia's denial to participate in the US Nunn-Lugar program, Washington's withdrawal from the Group of a civil society development in the Russian-American Presidential Commission, as well as cessation of cooperation under the Agreement on Cooperation in the fields of law enforcement bodies and drug traffic control.

Thereby, the ***Syrian issue*** was only being discussed until the position of the U.S. and Russia was unveiled. It is well-known that the latter aims to implement so-called Geneva agreements on Syria reached on June 30, 2012, in accordance with which the country's opposition and the ruling regime have to achieve an agreement through conducting negotiations and set a date of new elections in the country. However, due to the presence of open hostilities the parties, in fact, have failed to reach any meaningful decisions. Therefore, Russia's main objective regarding the prevention of foreign troop invasion of Syrian land is being implemented at the moment. Yet another question is how long will it last?

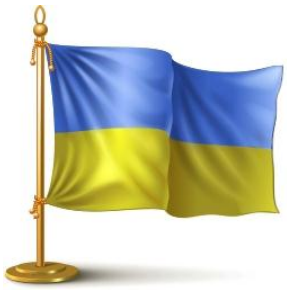
Much attention was paid to the subject of ***Iran's nuclear program***. Yet the Munich Conference parties were only able to restate the positions already being voiced. Tehran claimed there was no evidence of a military orientation of its nuclear program; while the Western representatives urged Iran to start making concessions. A date and place of the next round of negotiations involving six international mediators was announced at the conference. It was to be held in Kazakhstan on February 25, 2013. However, no particular decision was finally reached.

Russia, guided by its geopolitical interests, offered "***to clarify NATO's mission*** in Europe under new conditions." Thus, Russia appealed to the thesis that the European security should be provided not by NATO, but the OSCE. Although the latter, according to Russian representatives, is also dependant on the position of the United States. Therefore, it is high time to work out some unifying projects that would cement the European space and would help to build consensus on fundamental security issues. The basis should be grounded on the OSCE Council of Foreign Ministers' "Helsinki + 40" process approved in December 2012, calling for renewal of the organization on the threshold of the 40th anniversary of the Helsinki Final Act scheduled in 2015. However, Russia itself is not seeking renewal of negotiations even regarding the Treaty on Conventional Armed Forces in Europe (CFE), because it is not happy at all with the US requirement to annul the declaration of Abkhazia and South Ossetia's independence, as well as the paragraph on flanking restriction that does not allow to build up military forces in certain regions, on the so called 'flanks'.

However, the word 'Russia' was probably the most commonly uttered in Munich during the discussion on "shale gas production." According to some prognosis, the U.S. will be soon able to overtake Russia in thee terms of gas production. And it is Russia who will lose out most due to this 'shale gas revolution' as the world market gas proposals will increase and that will make prices fall. While talking about the 'shale gas revolution' in the world, the Munich Conference also mentioned Ukraine, which has signed a deal with Shell for the production of shale gas. Representatives of the European Commission have even suggested that Ukraine can one day become a gas exporter to Europe. However, Ukrainian officials failed to confirm or refute this suggestion. The Minister of Foreign Affairs of Ukraine, Leonid Kozhara's claim for participation in the event was not implemented. The forty-ninth Munich international security conference was conducted this time without the contribution of any Ukrainian officials. Although the level of representation during the February conference was very high including the foreign ministers of the world's leading countries, the leaders of NATO and the EU. Topics of discussion were important for Ukraine as well. Important topics discussed were the European crisis and the future of the European Union, global changes in the energy sector, and the future of NATO.

In fact, all multilateral contacts during the conference were reduced to settlement of pressing issues between Russia and the U.S. The two super actors were put in the middle of a so-called 'soft confrontation', and extrapolated their own contradictions on the process of European relations.

FOREIGN POLICY OF UKRAINE



KEY THEME ANALYSIS

Eurasian Integration of Russia: changing tactics without changing strategy

It seems as if the events related to Gazprom's reclamation of the 7 billion dollar debt resulting from insufficient gas withdrawal by Ukraine (according to Russia) as well as leaked information about negotiations on a bilateral Russian-Ukrainian consortium formation on the basis of Ukraine's gas transporting system (GTS) management symbolize the beginning of the country's passage into a major zone of turbulence, which can lead to a decline and a serious crisis in both the economy and politics even if gas prices are reduced.

If one ponders over the history of Russian-Ukrainian relations, one can say that Russia has always used price or debt instruments to achieve both economic and political goals in Ukraine. However, ***the political approach has always been dominant with its core aim to bring Kyiv into Russian integration projects***. This approach has ultimately suffered a setback because Kyiv tried to preserve its state sovereignty. However, Russia has been an absolute success in achieving conditions of gas supply for Ukraine's 'energy wasting' economy that are favorable for itself while unfavorable for Ukraine. Russia effectively used the Ukrainian elite's greed and highly corrupt expectations of those in power. These chronic disabilities of Ukrainian bureaucracy and elite's business have given Russia a possibility of introducing a beneficial gas trading scheme.

However, changing political and economic circumstances as well as realities of the European gas market have not contributed to a long-term existence of these schemes. Thus, RosUkrEnergo's scheme, which should have been enriching its initiators until 2028, endured merely until the end of 2008. Russia failed to include an infrastructure component in the scheme due to Ukraine's strong resistance to it. Gazprom's declared objective to "Restore a technological and organizational unity of the formerly single system of the USSR's gas supply" has remained an unattainable goal. Moscow believed that involving Ukraine in some model of Eurasian integration would help to settle the matter of control over its GTS in favor of Gazprom. Time passed, but the issue still remained unsettled. Putin's 'impromptu' for "merging Naftogaz and Gazprom assets in 2010 based on Russia's success in Kharkiv - the so-called 'Kharkiv arrangements'" did not work out as well. The situation has probably caused some revision of Russia's tactical approaches that could lead to the obtainment of strategic results.

Such opinion is corroborated by the prestigious Russian journal "International Life". Last year's publication cited one of the heads of the Institute of Energy Strategies of Russia indicating a slight shift in the practice of the Eurasian integration process. *"The experience of existing regional grouping of countries, including the European Union, has shown that the most robust supranational union structure is based neither on the single economic or customs area, nor common political values, but on the infrastructure connections, especially the energy infrastructure. … Everything mentioned above is true in relation to the Eurasian Union as well; the backbone of which can and should be the energy infrastructure."*

Some other documents formulate the idea of "a single overland energy (including gas) tunnel from the Atlantic to the Pacific through the territory of Russia." That means that a theoretical groundwork for Gazprom's future 'kickback pipelines' has been layed implying a long-term task to connect the "South Stream" pipeline through the "Power of Siberia" with Khabarovsk - Vladivostok gas pipeline.