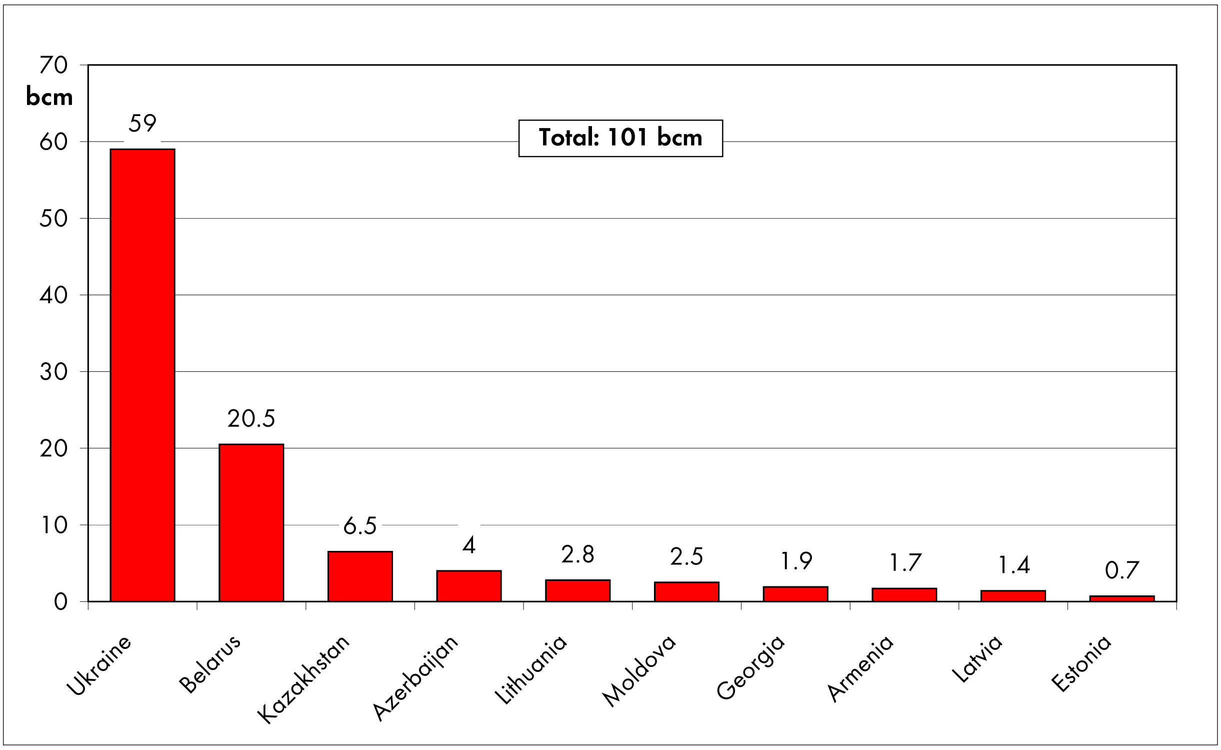
Diagram 3: Gas Sales Structure for the CIS and Baltic States in 2006, bcm



Source: Gazprom.

Analysis

The Natural Gas Conflict Between Russia and Ukraine

By Heiko Pleines, Bremen

Abstract

Ukraine depends to a large degree on Russian energy deliveries. At the same time, it is the most important transit country for Russian energy exports. The mutual dependency has created a stalemate situation and difficulties in the relations between the two countries. Compared to previous years, however, the conflict between Ukraine and Russia over the gas trade has relaxed noticeably, despite some dramatic interludes that remain. While 2006 saw a suspension of deliveries, a drastic deterioration of foreign policy relations, and a trade conflict, an agreement was reached in 2008 – albeit at the last moment – that was welcomed by all sides. The core problems remain unresolved, however.

Ukrainian Dependency

Just as during the Soviet era, Ukraine today remains dependent on energy imports from Russia, particularly oil and natural gas deliveries. Ukraine's production only covers 25 percent of its oil needs and 15 percent of its gas requirements. Since all existing oil and gas pipelines to Ukraine come from Russia, Ukraine has few alternatives to diversify its supply. Deliveries from Central Asia depend on the consent of pipeline operators controlled by the Russian state, monopolist Gazprom for natural gas and the state-controlled Transneft company for oil.

In Ukraine's complicated relationship with Russia, the trade in natural gas has proven noticeably more difficult than the oil business. There are two reasons for this difference. First, gas accounts for nearly 50 percent of Ukrainian energy use, making it the most important primary energy source. Second, Ukraine must deal with Russian gas monopolist Gazprom, whose good relationship with the Russian government gives it a strong negotiating position, allowing it to exert significantly more pressure than individual Russian oil companies would be able to bring to bear.

After the collapse of the Soviet Union, Russia began to charge Ukraine "normal" prices for energy deliveries. Dollar payments were demanded of Ukraine as early as 1992. Prices were raised incrementally. Ukraine was unable to meet its payment obligations under these contracts and found itself exposed to significant Russian pressure. In 1993, energy deliveries were drastically reduced, triggering an energy crisis in Ukraine in the winter of 1993/94. Many industrial enterprises had to cease production, public buildings were not heated, and streetlights were switched off. At this point, Ukraine's debts for Russian oil deliveries had reached US$600 million. Since Ukraine was obviously insolvent, Russia demanded shares in Ukrainian energy companies in compensation. However, Ukraine cited national security considerations for its categorical refusal to consider Russian participation in the gas industry during the 1990s.

Russian Dependency

Despite its high level of debts, Ukraine was not defenseless against Russian pressure. On the contrary, Russia was forced to accept that collection of payments receivable was only possible to a limited degree, due to the Russian dependence on Ukrainian transit pipelines for exports to Western Europe. In the mid-1990s, 95 percent of Russian gas exports and more than 50 percent of Russian oil exports to non-CIS countries passed through Ukraine. This transit trade allowed Ukraine, on the one hand, to alleviate energy shortfalls by illegally siphoning gas from pipelines. On the other hand, it could demand considerable transit fees from Russia.

An Initial Compromise

This stalemate led to the conclusion of an initial compromise in the mid-1990s. Under the agreement, Ukraine was to receive more than half of its gas imports in lieu of transit fees. Additionally, Russian leasing fees for Black Sea Fleet military bases on the Crimean Peninsula were used to repay Ukrainian energy debts. Furthermore, Ukraine aimed to repay its gas debts through barter deals, for instance through delivery of fighter-bomber aircraft to Russia. Direct cash repayments were apparently discontinued altogether. Gazprom accepted this arrangement in order not to endanger its gas exports to Western Europe. As a result, Ukrainian gas debts continued to rise.

Renewed Escalation

In early 2000, Ukraine owed Russia US$1.4 billion for gas deliveries. Gazprom demanded an additional US$700 million in interest, penalties, and refund payments for theft of siphoned gas. At the same time, Gazprom exported the first deliveries of gas through the Yamal Pipeline, which had become operational in autumn 1999 and whose route through Belarus and Poland avoided Ukrainian territory. The Russian gas corporation used the occasion to increase pressure on Ukraine once more. It aggressively pushed for a resolution of the debt issue and an end to gas thefts, while at the same time forging ahead with plans to build further alternative export pipelines circumventing Ukrainian territory.

In this way, Gazprom managed in autumn of 2002 to force Ukraine to take up negotiations on an international gas consortium that would administer the Ukrainian pipelines. In addition to Gazprom and Ukrainian partners, the negotiations also involved German gas importer Ruhrgas. However, no agreement was reached.

The Second Compromise

In the matter of debt settlement, however, progress was made. In April 2004, the sides adopted a plan that included considerable concessions to Ukraine. Gazprom reduced its repayment demands by US$200 million and accepted Eurobonds for payment of the remaining debts, with staggered payments to be made by 2013. Under an additional agreement in August 2004, the outstanding Eurobond payments were offset against Gazprom's transit fees until 2009. As a result, Ukraine had resolved its debt issues with Gazprom, but was no longer to receive gas in lieu of transit fees from 2005 onwards. Additionally, the price of Russian gas deliveries was fixed in a binding and "immutable" contract at US$50 per 1,000 cbm. This constituted a significant discount compared to the price charged for EU importers. However, this discount was largely financed by Turkmenistan, which delivered nearly two thirds of gas exports destined for Ukraine.

The 2006 Suspension of Deliveries

In autumn 2005, after the agreement to construct the Baltic gas pipeline had weakened Ukraine's leverage as a transit country, conflict broke out anew. Gazprom demanded an increase of the gas price to US$160 per 1,000 cbm from the beginning of 2006. When no agreement had been reached by December, Gazprom raised its price demand to US$230 and suspended deliveries to Ukraine at the beginning of the new year. However, it again became clear that the dependence on Ukrainian transit pipelines weakened Gazprom's position. When deliveries were stopped, Ukraine diverted gas from transit pipelines, calling the Russian action a violation of the bilateral treaty on gas supplies. As a result of Ukraine's gas siphoning, Russian supplies to the EU where considerably reduced. Pressure from the EU then forced Gazprom to resume deliveries to Ukraine.

The Current Arrangement

As early as 4 January 2006, Gazprom and the Ukrainian state company Naftohaz Ukrainy reached a provisional agreement. The price for Ukrainian gas imports was raised to US$95. At the same time, Gazprom was guaranteed a price of US$230 for its deliveries. The difference between the high price of Russian gas and the significantly lower price at which it was sold to Ukraine was passed on to the Central Asian suppliers, who were not involved in the negotiations leading to the agreement.

The fulfillment of deliveries to Ukraine was handed to an intermediary firm, Swiss-registered RosUkrEnergo, which is jointly owned in equal parts by Gazprom and private Ukrainian businesses. Ukrainian public opinion was critical of the involvement of RosUkrEgo, since the company was the subject of a public prosecution in Ukraine on suspicion of having links to organized crime and its ownership structure was opaque at the time.

The Ukrainian parliament used the opportunity of the agreement to bring a vote of no confidence against the government. At the same time, tensions continued to simmer in Russian-Ukrainian relations over matters related to the use of infrastructure on the Crimean Peninsula by the Russian Black Sea Fleet and a trade conflict focused on anti-dumping measures and import restrictions particularly for food and metal products.

In the subsequent years, the price of gas imported to Ukraine increased considerably, mainly due to price hikes and delivery shortages on the part of Turkmenistan. In 2007, the delivery price charged to Ukraine stood at US$130, and it was fixed at US$179.50 for 2008. Gazprom has announced further increases for the coming years. Within a few years, the price charged to Ukraine is to be aligned with EU prices for Gazprom's deliveries. The price Ukraine would have to pay then would be identical to that paid by EU countries, minus transport costs and tariffs. At the current pricing levels, Ukraine would then have to pay considerably more than US$200. The actual price would depend, however, on the development of global market prices for oil, to which the price of gas is tied.

The drastic price increases caused the value of Ukraine's annual gas import requirements to rise to over US$7 billion in 2007. Ukraine was now no longer able to compensate for the price hikes by increasing transit fees for Russian gas exports to the EU. While transit fees of US$1.5 billion in 2005 were sufficient to pay for half of the imported gas, the US$2 billion in fees collected in 2007 only corresponded to slightly over one quarter of import costs. If Ukraine delays payment by only a few months, the country will run up billions of US dollars in debt.

Since the state-run company Naftohaz administers the entire process of importing Ukraine's gas, it is ultimately the state budget that must pay off the outstanding debts. While the state adapts gas prices for industrial customers to increasing import prices, the supply of gas to private households is heavily subsidized. In 2006, private households paid only US$37 on average, while the import price had already climbed to US$95.

The Position of the Tymoshenko Administration

The long political crisis in Ukraine, with early parliamentary elections in September 2007 and the creation of a new coalition government under Yuliya Tymoshenko only in December, caused considerable debts from gas deliveries to accumulate again, while on the other hand, no agreement was reached on the delivery price for 2008. At the beginning of February 2008, Gazprom threatened to cut off deliveries to Ukraine unless remaining debts of US$1.5 billion were repaid within a short period of time.

Tymochenko, who represents a decided pro-Western course for Ukraine, had already accused Russia during the election campaign of politicizing the gas issue. She demanded that the dubious intermediaries be excluded and transit fees be raised drastically. At the same time, she demanded an overhaul of state company Naftohaz, which she accused of mismanagement.

On 12 February, Ukrainian President Viktor Yushchenko reached a last-minute agreement with his Russian counterpart Vladimir Putin in Moscow. According to initial media reports, Ukraine promised swift repayment, and both sides agreed to exclude intermediaries. At the same time, Gazprom will be permitted to deliver gas directly to Ukrainian end-users. The Ukrainian import price for 2008 was fixed at US$179.50. The details of the agreement remained unclear, however, even after Tymochenko held further negotiations in Moscow on 20 February.

In April the Ukrainian government declared that it had repaid all gas debts. However, although Tymoshenko announced the exclusion of all intermediaries beginning in spring 2008, a deal with RosUkrEnergo was made for the full year.

Conclusion

Compared to previous years, the conflict over the energy trade between Russia and Ukraine has experienced a marked relaxation despite occasional dramatic flare-ups. While 2006 still witnessed a suspension of deliveries, a drastic deterioration of foreign relations, and a trade conflict, an agreement was reached in 2008 – albeit at the last moment – that was welcomed by all parties concerned. The core issues remain unresolved, however.

As long as the import price of gas for Ukraine is not linked to the price of oil in accordance with EU practice, it will remain the object of politicized bargaining and therefore constitute a potential lever for the application of pressure in the context of Russian foreign policy. At the same time, the involvement of intermediaries causes a lack of transparency in the handling of payments and thus gives rise to suspicions of personal enrichment on the part of the Ukrainian tycoons and Russian managers involved. It is supremely ironic that Tymoshenko, who herself amassed a huge fortune in the dubious gas trade business during the 1990s, is now the one to demand strict action. Nevertheless, she does of course have a valid point. A neutral pricing formula and transparency in payment transactions are the only way to manage the gas trade in a way that is calculable and free from politicization.

At the same time, the rapid price increase for gas places a severe strain on the Ukrainian state budget and the national economy. Production costs in heavy industry and chemical industry are increasing, and there is substantial inflationary pressure. Handling the economic consequences of rising gas prices requires comprehensive modernization efforts in the industry, a state energy-savings program, and billing for private households based on individual consumption. In these areas, the Tymoshenko administration still has a lot of work to do.

About the author
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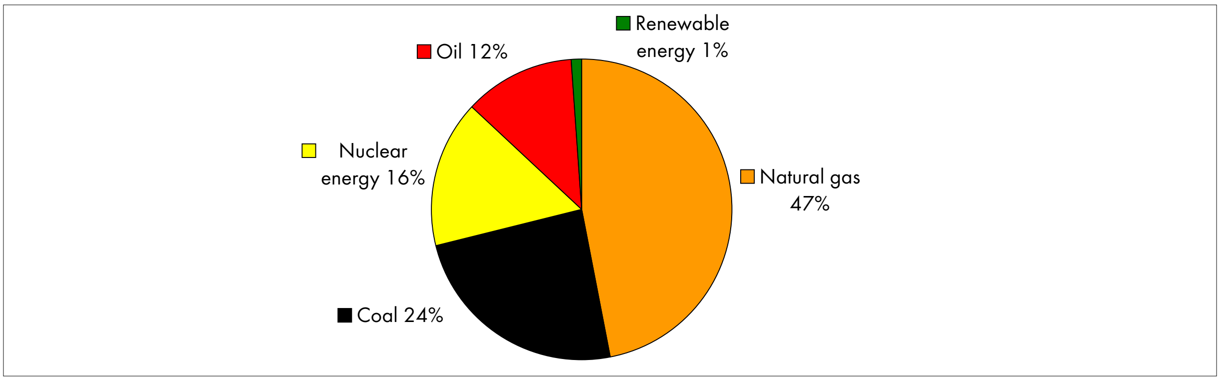
Tables and Diagrams

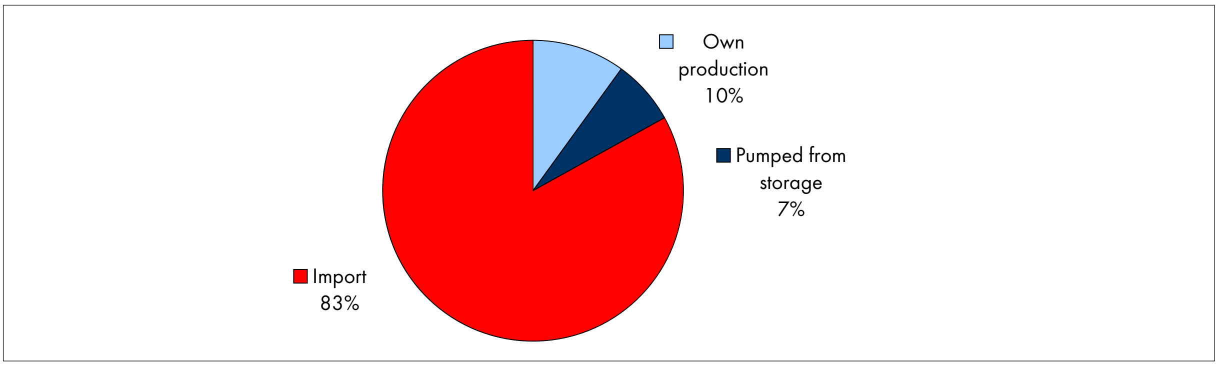
Russian–Ukrainian Natural Gas Trade

Diagram 1: Ukrainian Consumption of Primary Energy



Source: Ukrainian Ministry of Energy, http://www.mpe.energy.gov.ua/

Diagram 2: Sources of Ukraine's Natural Gas Supply (2006)



Source: Ukrainian Ministry of Energy, http://www.mpe.energy.gov.ua/