Analysis

The Russo-Ukrainian Gas Dispute, 2009

By Simon Pirani, Oxford

Abstract

The Russo-Ukrainian gas dispute, which has apparently just been resolved at the time of writing, is the most serious yet. The two sides were close to reaching agreement in October, and may eventually return to the framework established then. But sharply deteriorating economic conditions, resulting from the financial crisis and falling oil prices, have stoked the conflict, and helped to make both sides willing to prolong it. Russia's determination to solve what it sees as an intractable problem with Ukrainian gas transit is a more significant factor than the influence of oligarchs.

The Culmination of a Long Process

Russia's "gas war" with Ukraine this month continues a dispute that has turned nasty periodically since 1991. It is by far the most serious confrontation yet. Imports from central Asia via Russia to Ukraine stopped on 1 January, and from Russia via Ukraine to 18 other European countries on 6 January. In Bulgaria and other Balkan countries heavily dependent on imported Russian gas, many residents lost their heating and a humanitarian crisis resulted. The Russian and Ukrainian governments signed an agreement on 19 January that should result in supplies being resumed both to Ukraine and beyond, although the sides did not make public some details while others remained unsettled.

In the gas sphere, Russia and Ukraine remain bound to each other by Soviet-era infrastructure, long after other economic and political ties have weakened. Four-fifths of Gazprom's exports to Europe, its prime source of revenue, go through Ukraine's pipelines. Ukrainian industries, heating networks and housing, all designed to use then-cheap Soviet gas, remain, 20 years later, heavily dependent on mainly Turkmen supplies provided by Gazprom. (See Table 1 on p. 5.)

Supplies to Europe have been interrupted once before, in January 2006. Then, Gazprom was demanding an increase in Ukrainian import prices to European netback levels (i.e. to the level that its European customers pay, with the cost of transport through Ukraine, Slovakia and the Czech republic deducted). It also wanted to pay to transport gas through Ukraine in cash, instead of with the biggest of all remaining post-Soviet barter transactions (transit-for-gas).

The agreement that ended the 2006 dispute was good for Gazprom, inasmuch as it did away with barter deals and direct Ukrainian negotiations with central Asian suppliers, mainly Turkmenistan. Since then, Gazprom has bought all the gas central Asia sends west, and resold most of it to Rosukrenergo, a Swiss trading company owned by Gazprom (50%) and Ukrainian businessmen Dmitry Firtash (45%) and Ivan Fursin (5%), which then resells it in Ukraine. (Rosukrenergo was the last of a series of intermediary companies used by Gazprom to transport and/or resell central Asian gas to Ukraine. The practice began in the mid-1990s when barter was predominant and the entire gas trade unstable; its persistence into the 2000s has been criticized because of its opacity and the resulting scope for corruption, and because of favoritism shown by Gazprom to the intermediaries' owners.) The deal's negative aspects, from Gazprom's standpoint, were that Ukrainian import prices stayed far below European netback levels (See Table 2 on p. 6). And whereas in Belarus, Gazprom bought 50 percent of the pipeline company in 2007, Ukraine has refused to contemplate even partial Gazprom ownership.

When Yulia Timoshenko, the multi-millionaire former gas trader, returned to the Ukrainian prime minister's office in December 2007, renewed conflict seemed likely. She was determined to remove Rosukrenergo and its part owner Firtash from the gas trade. She ordered that Rosukrenergo and its affiliates be frozen out, leading to a brief "gas war" in March 2008. But then Moscow indicated it was ready to dispense with Firtash at year's end, and the conflict subsided.

So Near to Agreement, and Yet so Far

By October 2008, it seemed that Russia and Ukraine were ready to put their gas relationships on a new footing. Timoshenko and Russian Prime Minister Vladimir Putin signed a memorandum that provided for both import prices and transit tariffs to reach "market, economically based" levels (read, European netback) within three years; Gazprom would sell central Asian gas to Naftogaz Ukrainy, the Ukrainian state company (i.e. Rosukrenergo would lose its lucrative transit contract); and Gazprom subsidiaries would no longer be unwelcome in the Ukrainian domestic market. The deal, backed by a corporate agreement between Gazprom and

Naftogaz, was to be finalized once Ukraine had cleared debts for gas received.

Why did it all go wrong?

Firstly, because Ukraine failed to clear the debts promptly as it had agreed. Secondly, because the two sides failed to agree on how exactly European netback prices should be arrived at.

There were powerful economic factors that drove the dispute. Oil prices had reached an all-time high in July 2008 and were falling in the late summer; after the Wall Street financial meltdown of September, they plunged. Russia's oil boom was over. European gas prices are tied (indirectly, via oil products) to oil prices, but with a six- or nine-month delay. So Gazprom knew that, by mid-2009, its European revenues, too, would be slashed. Its managers were in no mood to give up a single kopeck.

The coming recession is hitting Ukraine even harder than Russia, as the IMF recognized by granting it a record-breaking $16.5 billion loan. The price of steel, Ukraine's main export, has sunk; most of its mills have lost up to half of their output and more than half of their revenues. December's industrial production was down 26.6% year-on-year.

Perversely, this gave Ukraine room for maneuver, gas-wise. The world's most energy-inefficient economy was contracting, for the first time this decade, and so needed less gas. Mild weather late last year helped. Naftogaz had 17 billion cubic meters (bcm), about one-third of Ukraine's annual import requirement, in storage. Some politicians may have decided this was the best time for a prolonged dispute with Russia.

Ukraine failed to pay its debt for last year's imports ($1.5 billion, it says; $2.2 billion including late payment penalties, Russia says) until 31 December. Along with the money, Naftogaz sent a letter saying that if Ukrainian supplies were cut, it would divert to its customers volumes bound for Europe, as it had in 2006. Gazprom had been publicly threatening to cut off Ukraine for two weeks already. On 1 January it did so.

How Europe Became Embroiled

Even at this stage, a deal seemed close. On 31 December, Putin said it should be done on import prices of $250 per thousand cubic metres (/mcm). On 1 January, Timoshenko and president Viktor Yushchenko, in a rare show of unity, proposed $201/mcm and an increased tariff for transiting Russian gas to Europe.

But the leaders displayed little will to clear away practical obstacles. Naftogaz promised to transit gas to Europe even while its own imports had ceased. But on a legalistic pretext, it added that, until new contracts were signed, it could not supply technical gas (i.e. amounts required to power compressors and other equipment) as transit countries normally do. It would take these from the Russian gas provided. Gazprom countered that this was "theft", no better than the crude siphoning of the 1990s.

On 5 January, Gazprom cut the volumes going into the pipes by about one fifth, arguing that Ukraine should replace the technical gas it had taken; on 6 January, Gazprom cut volumes by a further three-fifths. In the early hours of 7 January, the system was shut down completely and Russian deliveries into it stopped. Both sides blame the other: Russia says Ukraine stopped accepting deliveries, Ukraine says Russia stopped making them. Neither outside observers, nor even some people in the industry, yet know the real story. But it became obvious in succeeding days that both sides were happy to sit it out, however many households in the Balkans froze.

The European Commission, which had prior to 6 January kept aloof, now called both sides to Brussels, and suggested sending monitors to gas metering stations, to help avoid more rows about which gas was going where. An agreement was drawn up, but when Timoshenko signed it, she added reference to a list of conditions to which she knew Gazprom could not agree. On 13 January Gazprom agreed to supply gas via one pipeline only (out of five main ones), but Ukraine said it could not transport it without disrupting its own consumers. The next day, as demonstrators clashed with police in Sofia, negotiators agreed to meet … after another three days.

On 19 January, both sides announced that they had resolved the dispute. Gazprom and Naftogaz signed two separate ten-year agreements, one on gas supplies to Ukraine and one on transit. Putin and Timoshenko announced that in 2009 discounts would be applied both to Ukraine's import bill (by 20%), and Russia's transit bill (it will stay at the 2008 level), but that from 2010 – a year earlier than they had previously envisaged – prices would be set at European netback and transit fees at a European comparator. Rosukrenergo would lose its transit contract.

At the time of writing, the exact price of Ukrainian imports in 2009 had not been agreed. Gazprom said gas would start flowing immediately after the signing, and would take about 36 hours to reach European destinations.

Motivations

During the dispute, with European gas prices at their peak, Gazprom has been losing close to $100 million a day in revenues after costs. It has lodged cases against Naftogaz at the international arbitration court in Stockholm, but it will be years, if ever, before it recovers anything that way. More importantly, the unprecedented interruption to European supplies has cost Gazprom more than money. It has suffered damage, probably permanent, to its reputation as a reliable supplier – which was already under constant attack from commentators, often ill-informed, who see Russian gas primarily as a geopolitical "weapon".

What would make Moscow prolong such an expensive stand-off? Evidently, it has been decided at the government level that pursuing, and somehow punishing, Ukraine is worth risking a great deal. This conflict is not simply about gas prices. The gap between Putin's $250/mcm and Yushchenko-Timoshenko's $201/mcm is roughly $2–2.5 billion a year in revenue, to be shared with traders and central Asian producers – compared to $30–40 billion from European sales.

A more plausible interpretation is that people in the Russian government hope that, by embroiling Europe in the dispute, a new modus operandi can be established for the Ukrainian pipeline system. Much of what Europeans usually term Russian supply risk is actually Ukrainian transit risk, and that concerns Moscow. Ukraine's readiness to divert gas bound for Europe, as it did in 2006, has been a trump card in negotiations. On one hand, Russian suggestions that Ukraine might relinquish control over the system to pay its gas debts, as Belarus did, meet blanket and understandable political opposition in Kiev. On the other, Naftogaz has failed to raise money to refurbish the system, and struggles even to maintain it.

Gazprom managers, in response to what they see as an intractable obstacle, after 2006 pressed ahead with projects such as the North Stream and South Stream pipelines, aimed at reducing transit dependence on Ukraine. But these won't be ready for three more years at best, and won't cut out Ukraine all together even then. For Moscow, control of the Ukrainian network remains the favored option. But, short of that, it would prefer closer European engagement with transit issues. Putin resurrected the idea of an international consortium to take over the system in a recent interview. And the heads of German and Italian energy companies, Gazprom's most important European partners, met with Putin on 15 January to discuss how to resolve the sticking-point on technical gas.

What about the oligarchs, the politically-influential businessmen so prominent in Russia and Ukraine? The press is full of suggestions that, while public attention focuses on the governments, "the real fight over the share-out [of gas revenues] is taking place more discreetly between a few oligarchs in Moscow and Kiev", as a comment contributed to the *Financial Times* (6 January) put it. But there is no evidence that Ukrainian gas oligarchs matter sufficiently to the Russian government, or have sufficient influence on it, to provoke a clash on this scale.

Take Dmitry Firtash, the most significant of them. His businesses are relatively opaque, as are his political connections, but the main sources of revenue are known. Assuming that Rosukrenergo loses the contract to ship central Asian gas to Ukraine – as it will if the agreements signed on 19 January are implemented – it may continue selling 7+ bcm/year of central Asian gas in central Europe (extremely profitable) and buying local gas distribution networks in Ukraine (extremely unprofitable, so far). Firtash's companies also manufacture chemicals, and trade gas and electricity in central Europe. All significant – but no reason for Gazprom to put its European revenues on the line.

Prices and Transit Tariffs

The Putin-Timoshenko memorandum proposed that Ukrainian import prices should rise to "market" (in practice, European netback) levels in three annual steps. A Ukrainian government memorandum to the IMF said domestic prices should rise in the same way.

The two prime ministers said on 19 January that they are now hoping to reach European netback prices for Ukraine by 2010, a year earlier than they had initially planned. The real struggle for Ukraine will be this year, because European prices will reflect record-high oil prices in 2008. In the first half of this year, European prices will be roughly $450/mcm; that, less transport costs and a 20% discount, is about $325/mcm. In the second half of 2009, European prices will be about $350/mcm. If they stay at that level in 2010, European netback in Ukraine would be $306/mcm; if they fell to their average level in 2006–07, roughly $250/mcm, European netback in Ukraine would be a little higher than $200/mcm.

Ukraine also insists that transit tariffs, now $1.70/mcm per 100 km, should rise. Czech and Slovak tariffs, the best comparators, are not made public. But there seems to be a large differential, more than 100 percent, just as there is on gas import prices. If the gap in prices isn't closed in one jump, the two sides will not be able to close the gap in transit tariffs either. Moscow might engage with the figure in the Timoshenko-Yushchenko memorandum, $2/mcm per 100 km, but not with the $3.60-4/mcm per 100 km mentioned later by Yushchenko.

Consequences

The most immediate consequence of the dispute will probably be an acceleration of North Stream, South Stream and other projects to diversify transit of Russian gas away from Ukraine, on which Gazprom has agreed with European energy companies, but on which construction has not yet begun. European politicians will talk about projects to diversify supply of gas away from Russia, and alternative fuels. But such plans will remain constrained by European energy companies, who will prefer to adapt their long-standing relationship with Gazprom than to make big investments in other uncertain energy sources.

This could be the "war to end wars" in Russo-Ukrainian gas relations. Short term, it may mean changes in Ukrainian transit arrangements. Certainly, once transit diversification projects are completed, the Ukrainian pipelines will be less important to Russia, and less of a bargaining chip for Ukraine. In the best case, Ukraine will get serious about energy efficiency, the only effective way for it to reduce dependence on imported gas in the long term.

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Further reading:

- Simon Pirani (ed.), *Russian and CIS Gas Markets and Their Impact on Europe* (Oxford University Press, forthcoming in February 2009)
- Simon Pirani, Jonathan Stern and Katja Yafimava, *The Russo-Ukrainian gas dispute of January 2009* (OIES, forthcoming in February 2009)

Tables and Graphs

The Gas Dispute in Figures

Table 1: The Russo-Ukrainian Gas Trade: An Outline

Imports

	2003	2004	2005	2006	2007	2008 (est.)
Ukraine, consumption	68.7	68.1	68.9	65.9	62.8	60
Ukraine, technical requirements	7.6	7.6	7.4	8.1	7.0	7
Ukraine imports (presumed)	56.9	55.4	55.8	53.3	49.1	47
Ukraine production		19.4	20.3	20.5	20.7	20.7
Price ($/mcm)	$50	$50	$44–80	$95	$130	$179.5
Total value of imports, bn $ (estimates)	$2.84bn	$2.77bn	$3.2bn	$5.06bn	$6.38bn	$8.44bn

Transit

Volumes transported, bcm/year						
To Europe	112.4	120.3	121.5	113.8	112.1	113
To the CIS*	16.8	16.8	14.9	14.7	3.1	3
Cost of transit $/100km/mcm	(barter)	(barter)	$1.09	$1.60	$1.60	$1.70
Value of transit services, bn $ (estimates)	$1.48bn	(n/a)	$1.5bn	$2.2bn	$2.1bn	$2.2bn

** These are volumes transited to Moldova, and via eastern Ukraine to southern Russia. The latter volumes were sharply reduced in 2007 due to new internal Russian pipelines being commissioned.*

Source: statistics from Energobiznes, based on information from the fuel and energy ministry (consumption, import, production); Naftogaz Ukrainy (transit volumes); author's calculations