

Gas as an instrument of Russian pressure on Ukraine

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On 26 January the *Financial Times*, citing a source in the Ukrainian government, reported that Gazprom had issued a bill for US\$7 billion to Naftogaz for the purchase in 2012 of a smaller amount of gas than that agreed in their 2009 contract, due to a 'take or pay' clause. The same day, a Naftogaz spokesman confirmed the British newspaper's report. A Kremlin spokesman told the *Vedomosti* newspaper on 28 January that Gazprom had informed the Russian government of its action towards Ukraine and received approval. So far, the Russian government has not commented on the situation. Ukraine's foreign minister Leonid Kozhara and energy minister Eduard Stavitsky maintained that Ukraine is meeting the terms of the gas contract, and they described Gazprom's claims as unjustified. At the same time, they expressed hope for an agreement, and declared their readiness to negotiate.

Gazprom's action is not intended so much to get Ukraine to pay the amount it claims – which would be unrealistic, due to their different interpretations of the contract's provisions – but rather to use the matter of the undelivered gas as a key instrument for putting political pressure on the Ukrainian government. Moscow has consistently sought to force Ukraine to join the process of integration within the Customs Union. It should be expected that the Russian-Ukrainian gas dispute will continue to grow over the coming months, and that Moscow may also bring other instruments of economic pressure to bear.

The legal aspects of the gas contract

Russia's gas supplies to Ukraine are based on the contract for delivery over the period 2009-2019, which was signed in January 2009 by Naftogaz and Gazprom, and provides for the purchase by the Ukrainian company of 52 bcm of gas per year. In April 2010, the presidents of Ukraine and Russia signed an annex to the contract (the so-called Kharkiv agreement), which changed some of its provisions (including the abolition of the draconian punishment for failing to collect gas). According to the agreement, Naftogaz may reduce imports of a fixed amount of gas (52 bcm) by 20%, i.e. to 41.6 bcm, upon agreement by both parties at least six months before the beginning of the year of the alteration. At the same time, the document allows Naftogaz to reduce gas purchases by an additional 20% without the need to agree this with Gazprom. As a result, the minimum amount of gas which the Ukrainian company must receive or pay for (with the prior consent of the Russian side) – on the basis of the 'take or pay clause' – is 33.3 bcm (41.6 bcm minus 20%).

In 2012 Naftogaz bought only 24.9 bcm of gas from Gazprom. In addition, about 8 bcm of gas was imported from Russia by the Ostchem Holding company, which is owned by the Ukrainian businessman Dmytro Firtash. This was possible because in April 2011 the Ukrainian government decided to abolish Naftogaz's monopoly on importing gas, which paved the way for the emergence onto the market of other importers of Russian gas; this in turn led to a decline in Naftogaz's market share. The Ukrainian company argues that it informed Gazprom that it would reduce its 2012 gas imports to 27 bcm. However, this has not been officially confirmed by Gazprom, whose agreement that Naftogaz may reduce the amount of gas it purchases is essential. This volume of imports would constitute a further violation of the gas contract, which sets the minimum amount of gas that Naftogaz must import (by arrangement with Gazprom) at 33.3 bcm. The Ukrainian side maintains that the total amount of gas purchased in 2012 by Naftogaz and Ostchem Holding (which totals about 33 bcm) is consistent with the minimum amount that Ukraine must buy from Gazprom annually.

However, the Russian company has taken the position that Naftogaz was obliged to take delivery of at least 41.6 bcm of gas, but actually bought only 24.9 bcm. In this case, the total imported gas does not include the quantity imported by Ostchem Holding. As a result, Gazprom issued Naftogaz with a bill to the tune of US\$7 billion as payment for the uncollected gas, which amounts to 16.7 bcm (the difference between 41.6 and 24.9 bcm).

Russia's real goals

Gazprom's actions towards Ukraine are a result of the failure of the Russian-Ukrainian negotiations (which have been ongoing for several months) on both the change in the price of Russian gas, and – above all – Ukraine's possible accession to the Customs Union. Both parties seemed close to an agreement last December; a visit by President Yanukovich to Moscow was announced, during which a broad economic and political agreement would most likely have been signed. However, the visit was cancelled at the last minute, probably because Kyiv had failed to consent to certain points of the agreement (no specific details of the agreement as prepared are known).

The issue of payment for the gas Naftogaz has not collected is an essential instrument for Russia in strengthening its position in further negotiations with Ukraine. Moscow hopes that it will thus encourage Kyiv to make the expected concessions, above all to join the Customs Union; this move would block the signing of an Association Agreement with the EU, which is currently the most important objective of Russia's policy towards Kyiv. At the same time, Russia is aware of Ukraine's growing economic difficulties (the recession; the need to repay about US\$10 billion in foreign debts in 2012; Naftogaz's enormous debt), and hopes that by exerting pressure on the Ukrainian government, it will force them to make far-reaching concessions.

Forecast

Ukraine will not pay the bill issued by Gazprom, both due to a lack of funds, and to the belief that it is in the right. Despite this, it is now unlikely that Russian gas supplies to Ukraine will be interrupted. Ukraine is making its current payments for gas received, and in accordance with the provisions of the 2009 gas contract, the parties have thirty days to rectify the resulting disputes. If this has not happened after that period, then the disputes may be referred to arbitration in Stockholm; but the court of arbitration's judgement is very difficult to predict. The Ukrainian government would probably refer to the lifting of Naftogaz's import monopoly in 2011, argue that the total imports of Russian gas should include the quantity from Ostchem Holding, and try to undermine the 'take or pay' clause and the overly high price of gas charged by Gazprom. However, it seems that neither side is interested in bringing the dispute to the court.

The gas dispute is likely to get worse over the coming months, because Kyiv has declared that it intends to reduce its imports of Russian gas even further in 2013. Meanwhile, Russia sees gas issues as its most important instrument for putting economic and political pressure on Kyiv, in order to force it to accede to Russia's integration project. It is also possible that Moscow could use other instruments to pressurise the Ukrainian government, including the introduction of import duties on certain Ukrainian goods. Russia is determined to use Ukraine's economic difficulties to bring about its own political interests.

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