

Ukrainian-Russian gas dispute

Sławomir Matuszak

In recent weeks, Ukraine made yet another attempt to renegotiate the unfavourable gas contracts with Russia which were signed by Yulia Tymoshenko in 2009. The chances of success appear to be illusory, because without far-reaching concessions from Ukraine (for which it is not ready at present), Russia will not change the conditions which favour Moscow. If the talks collapse, it is to be expected that Ukraine will submit an appeal to the Court of Arbitration in Stockholm. At the same time, options leading to confrontation with Russia, including a 'gas war', seem unlikely, as long as Ukraine does not find itself in a critical economic situation. On the other hand, Ukraine's desire to renegotiate its contract with Russia could encourage it to accelerate the transformation of Naftogaz, Ukrainian state-owned gas monopoly, in accordance with EU regulations.

The 2009 gas contracts and their consequences

In January 2009, as a result of the 'gas war', Ukraine's Naftogaz and Russia's Gazprom signed an agreement on gas supplies until the end of 2019. It established a formula specifying the price of gas for every quarter – US\$450 per 1000m³, multiplied by a factor dependent on the price of fuel oil and diesel fuel (or indirectly on oil prices). According to the contract, Ukraine was obliged to buy at least 33 billion m³ of gas annually, according to the 'take or pay' clause. In addition, it was forbidden to re-export the imported gas.

After the adoption of this pricing formula, it soon became clear that Ukraine was paying some of the highest prices for gas in Europe. The increase in the oil price, which at the time of signing the contract was low, led to a systematic increase in gas prices. This became a major stimulus for Kiev to sign the 'fleet for gas' agreement in April 2010, by which Ukraine obtained a discount of 30% on the gas it received (but not more than US\$100 per 1000m³) in exchange for the extension of the lease to station Russia's Black Sea Fleet in Sevastopol. However, this agreement did not resolve the two main problems, from Kyiv's standpoint, with the contracts with Russia: the unfavourable pricing formula and the 'take or pay' principle. In 2011, the price of gas for Ukraine has continued to rise significantly; and despite reductions, it was higher in the third quarter than it was when the 'fleet for gas' contract was signed (see Appendix 2).

If there is an economic slowdown in the future, Ukraine will have serious problems using the contracted gas. In addition, the 'take or pay' clause blocks Ukraine's diversification projects (the construction of a gas terminal) and their plans to increase their own production (natural gas on a shelf in Ukrainian territory, methane, etc.). It also lowers incentives to implement energy-saving policies.

Why the dispute has worsened, and Russia's position

Multiple meetings between Ukrainian and Russian representatives on gas issues over the past year have not had any effects. The negotiations so far have taken place behind closed doors, with no details of the proposal being revealed. But in recent weeks, the talks have been publicised by Kiev. The main impetus for this is the need for Naftogaz to purchase more than 11 billion m³ of gas in the fourth quarter of this year, which would mean an expense of over US\$4 billion.

Russia will allow a change to the contracts, although this has been accompanied by far-reaching demands. First, Moscow wants Naftogaz and Gazprom to merge, which would mean Russia's *de facto* takeover of Ukraine's entire gas sector. However, the present market conditions (greater demand for gas) appear to mean that the Ukrainian government – even though it sees the unfavourable gas contract with Russia as a major economic problem – is not in such a bad situation that it will be forced to accept Moscow's demands.

In addition, another emerging demand by Russia is that Ukraine should join the Customs Union of Russia, Belarus and Kazakhstan. Not only would that undermine Ukraine's negotiations on an Association Agreement with the EU, which are now in the final stage; but such a move would also be incompatible with Ukraine's membership of the WTO. Ukraine joining the Russian-created Customs Union should therefore be seen as Moscow's ultimate goal.

What will Ukraine do?

If the talks fail, it is very likely that Ukraine will appeal to the Court of Arbitration in Stockholm, in accordance with the procedure laid down in the contracts. Impetus for such a decision may be provided by similar cases which energy companies in Italy and Germany have referred to arbitration. In July this year, Gazprom decided to reach a settlement with Italian Edison, without waiting for a ruling. The Ukrainian government wants to prove that the aforementioned contracts were concluded in violation of established procedures. This was one of the reasons (along with questions of internal politics) why Yulia Tymoshenko has been prosecuted on charges of signing gas contracts which were in violation of Ukrainian law.

Prime Minister Mykola Azarov announced that the contracts' obligations will be met until a new agreement with Russia has been reached. On the other hand, the Ukrainian authorities have suggested the possibility of challenging the contracts, and have also presented a plan to reform Naftogaz, which might in their view lead to a change in the contracts with Gazprom. The Ukrainian Prime Minister has announced that as part of restructuring Naftogaz (which is provided for in the memorandum agreed with the IMF, and which results from Ukraine's membership of the Energy Community), the company would cease to exist as an economic entity. In fact, the elimination of Naftogaz itself would not lead to the cancellation of the contract, as its obligations would be assumed by whichever company takes its place.

Conclusions

1. Ukraine's announcement that it will revise the contracts should be seen as an attempt to strengthen its negotiating position at the present time in its talks with the Russians. If these talks fail, Ukraine will probably appeal to the tribunal in Stockholm. It is difficult to assess what Ukraine's chances of a favourable ruling are, but the process would take several months at least (the average waiting time for a decision is two years).
2. Despite media speculation, there is no basis to the possibility of a 'gas war' in the coming months. The pretext for the conflict in late 2008 and 2009 was the lack of a fixed price for gas. The current contracts regulate all issues related to supply, and it is doubtful that Ukraine will decide to violate or breach the gas contract as long as it remains able to meet its conditions, and Kyiv has not exhausted all other possibilities to resolve the dispute. The price of gas should start to fall next year, in anticipation of the reduction in oil prices. Although these contracts represent a serious burden on the budget, Ukraine will still be able to cope, unless there is a sharp deterioration in economic conditions.
3. Russia is only likely to agree to amend the contract in exchange for far-reaching concessions from Ukraine, such as giving up its control over the gas pipeline system. However, unlike in 2010, Ukraine is not in such a critical situation, and it seems unlikely that the government in Kyiv will decide to make another agreement like the 'fleet for gas' one.
4. The current Ukrainian-Russian dispute may accelerate the process of restructuring and dividing up Naftogaz in accordance with Ukraine's obligations to the Energy Community. We may imagine that Ukraine will agree to Russia's entry into one of these successor companies, while Kyiv retains control over the rest of its energy sector.

Slawomir Matuszak, co-operation: Marta Jaroszewicz

Appendix 1

The interdependence of Russia and Ukraine in the gas sector

- Gas plays the most important role in Ukraine's energy balance (40%), and the Ukrainian economy is one of the world's most energy-intensive.
- In recent years Ukraine has consumed 55-70 billion m³ of gas annually, of which about 20 billion m³ comes from its own production, and the rest is imported from Russia.
- In turn, Russia is dependent on gas transit through Ukrainian territory to European countries (approximately 75%).
- Activating the Nord Stream pipeline could cause a drop in transit through Ukraine of about 20%, but Russia's dependence on Ukraine will continue.

Appendix 2

**How the price of
Russian gas to
Ukraine has
changed in 2010-
2011
(in US\$ per 1000
m³)**

1st quarter 2010	2nd quarter 2010	3rd quarter 2010	4th quarter 2010	1st quarter 2011	2ndquarter 2011	3rd quarter 2011	4th quarter 2011**
306	336/236*	348/248	352/252	364/264	397/297	454/354	500/400

** with / without
the discount from
the 'fleet for gas'
agreement
** forecast*