

Russia and Ukraine's 'cold gas war'

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On 16 June Gazprom announced that a pre-payment mechanism in gas transactions with Ukraine had entered into force. The company has taken this position as a consequence of the failure of Ukrainian-Russian gas negotiations. These began on 2 May and have been focused on the payment of Naftogaz's current debt (according to Gazprom, this is nearly US\$ 4.5 billion) and on Kyiv's demands on lower price. The direct result of Russia's decision is that gas supplies to Ukraine have been cut off until the debt is settled. At the same time the two parties announced they had initiated legal proceedings at the Arbitration Tribunal in Stockholm: Gazprom was claiming that it is owed money for supplies whereas Naftogaz was insisting that Gazprom return US\$ 6 billion for gas already supplied, at what Ukraine considers to be an inflated price over the period 2010-2013.

The fact that the gas supplies to Ukraine have been stopped will not affect any of the parties in this dispute because Ukraine has stored substantial gas supplies which will meet the country's needs until autumn. Kyiv declares that it will ensure the transit of the Russian gas to the EU without obstacle. The fact that both countries turned to the Arbitration Tribunal is rather a tactical move on each side and does not rule out further talks. Moscow, having decided on a gas 'cold war' with Kyiv, will continue discrediting Ukraine as a transit country and exert pressure on the European Commission in order for it to make decisions regarding the South Stream and Nord Stream gas pipelines which are favourable to Russia. As for Ukraine, it has started a battle for an overhaul of the 2009 gas contract which is unfavourable to Ukraine, including the change in the price formula and the elimination of the 'take or pay' clause. Both countries are prepared for lengthy litigation as they are aware that the future model of bilateral gas co-operation is at stake, that being one of the key aspects of Russian-Ukrainian relations.

The failure of the gas negotiations

The Russian-Ukrainian negotiations started on 2 May with a meeting held in Warsaw between the Russian and Ukrainian energy ministers, Yuriy Prodan and Alexander Novak, the CEO of Gazprom Alexei Miller and the EU Commissioner for Energy Günther Oettinger. The talks focused on Ukraine's debt to Russia (according to Gazprom, the debt for unpaid gas supplies from November 2013 to May 2104 stands at US\$ 4.5 billion) and Ukraine's demand to reduce the gas price to US\$ 268.5 and to change the price formula. Following the annexation of Crimea, Russia unilaterally revoked a US\$ 100 reduction in the gas price which Ukraine obtained on the basis of the 2010 Kharkiv agreement (the 'fleet for gas' agreement) and started demanding payments at the level of US\$ 485. Kyiv claims that this

reduction is still in effect and is demanding an even lower price, pointing to the agreements signed in December 2013 between Gazprom and Naftogaz which temporarily reduced the price to US\$ 268.5.

During the talks compromises were suggested: Ukraine signalled its readiness to accept a price of US\$ 326, while Russia declared it would be willing to reduce the price from US\$ 485 to 385. At the last stage of the negotiations (14-15 June) the European Commission put forward its compromise proposal which was accepted by Ukraine: Naftogaz was to pay one billion US dollars by 16 June, the remaining part of the debt would be paid in six instalments by the end of 2014 and the gas price for Ukraine would be "broken up into" a winter price (US\$ 385) and a summer price (approximately US\$ 300). Russia rejected this proposal.

The fact that Russia held gas talks with Ukraine, declared it was ready to make concessions regarding the gas price and twice postponed the date of introducing the pre-payment mechanism might signal Moscow's willingness to reach agreement. On the other hand, the details of the Russian proposal (a reduction in the gas price via a reduction in the export customs tariff by US\$ 100), Gazprom's firm opposition to the proposal change the price formula (Naftogaz made the payment of the debt dependent on this) and the rejection of the compromise solutions suggested by the European Commission all show that Russia was ready to escalate the gas dispute.

Launching the arbitration proceedings

On 16 June Gazprom announced that it had opened legal proceedings against Naftogaz at the Arbitration Tribunal in Stockholm in order to recover the debt. Naftogaz informed that it filed a complaint at the Arbitration Tribunal with the demand that a 'fair and market-based' gas price be set and that Gazprom would be required to return US\$ 6 billion for inflated payments for gas paid since 2010.

The launching of the legal proceedings at the Arbitration Tribunal by Gazprom and Naftogaz is unprecedented in Russian-Ukrainian gas relations. The verdict issued by the Tribunal does not necessarily have to lead to unequivocal settlements. However, Ukraine stands a considerable chance of having the price of Russian gas reduced via arbitration. The current price demanded by Gazprom (US\$ 485) is US\$ 105 higher than the average price which was in effect in 2013 in Gazprom's long-term contracts with European recipients and by US\$ 95 higher than the average prices on European spot markets in 2013. Recovering the overpayment of US\$ 6 billion for Russian gas supplies, however, will be much more difficult since Naftogaz did not question the contract regulations earlier and by settling ongoing payments for gas supplies it de facto accepted their price. Gazprom stands a substantial chance of obtaining a favourable verdict regarding the payment of the current debt by Naftogaz, although it is likely that the debt's final amount will be lower (Gazprom calculates the level of Naftogaz's debt for April and May based on the price of US\$ 485, which is being challenged by Kyiv).

Nevertheless, given the length of arbitration proceedings (they could feasibly last up to three years) it is likely that the complaints filed are elements of a negotiation tactic being made use of by both countries. This is confirmed by the statements made by both parties. The CEO of Naftogaz Andriy Kobolev said that Ukraine could do without Russian gas until December

2014 but added that he hoped to reach a compromise, while Gazprom's CEO Alexei Miller firmly announced that all talks may be continued only after the debt has been paid in full but added that the payment of any amount by Naftogaz would mean a completely new situation.

Moscow's objectives...

Moscow's objective is to consistently discredit Ukraine as an unreliable trading partner (it doesn't settle its gas debts) and transit country as Gazprom is signalling that if Ukraine does not fill its gas storage facilities up to the level of 18-19 billion m³ by autumn this year, this may result in problems with gas supplies to European recipients. In parallel, Moscow is trying to use the gas conflict with Ukraine in order to put pressure on the European Commission to make decisions with regard to the South Stream gas pipeline project (stopping challenging its compatibility with the third energy package) and the Nord Stream gas pipeline (reaching a decision enabling the use of full capacity of the OPAL gas pipeline which is the land extension of Nord Stream).

...and Kyiv's objectives

The new government in Kyiv is determined to negotiate not only a lower gas price with Gazprom but also to revise the 2009 gas contract which has had disastrous consequences for Ukraine. The high price of Russian gas is one of the causes of Ukraine's economic problems in recent years (the cost of purchasing Russian gas, subsidised to a large extent from the state budget, rose from US\$ 8 billion in 2009 to US\$ 12 billion in 2013). Kyiv's negotiating position is stronger now than during the winter gas conflicts in 2006 and 2009 due to falling consumption in summer, the importance of filling gas storage facilities (14 billion m³) and domestic production. Furthermore, from September this year Naftogaz is planning to launch gas supplies from Slovakia (3 billion m³ annually). Kyiv hopes that with a favourable verdict at the Arbitration Court, Gazprom will be more inclined to make concessions.

The declarations and measures taken by the Ukrainian government also indicate that Kyiv is attempting to challenge the existing model of gas co-operation with Gazprom which is unfavourable for Ukraine and gives Russia the possibility to exercise political influence over Ukraine. The Ukrainian government is planning, among other measures, to implement the third energy package regulations and has announced the establishment of an operator for the administration of the Ukrainian gas pipeline system. According to Prime Minister Arseniy Yatsenyuk's statement of 19 June gas pipelines and storages will remain in the state's hands but Kyiv is ready to transfer up to 49% of shares in the operator to Western companies. This would be a further reverse for Gazprom after it devoted many years to take control of Ukraine's transit gas pipelines and it would also affect Russia's strategic interests. On 21 June the government in Kyiv demanded that the Energy Ministry and other state institutions develop plans to prepare for the heating season should there be no supplies of Russian gas.

The outlook for the development of the gas conflict

The fact that Russia has stopped supplying gas to Ukraine and that Gazprom and Naftogaz have filed complaints to the Arbitration Court indicate that there has been a serious escalation in the gas conflict but that in the following weeks the measures taken will not have any negative implications for either party. Ukrainian stockpiles of gas and low gas consumption in summer make it possible for it to give up importing Russian gas for as long as until November-December 2014. Nor will the freezing of gas supplies to Ukraine have a negative impact on European recipients in the next two-three months as Kyiv is fulfilling its transit obligations.

In the immediate future it is rather likely that bilateral or trilateral negotiations will be resumed. Ukraine and the European Commission have already declared they are prepared to organise another meeting at the beginning of July. However, even were the talks to be resumed, it remains uncertain that a lasting agreement will be reached. It cannot be ruled out that Russia will try to maintain the state of the gas conflict until autumn in order to strengthen its negotiating position and that it will further escalate the conflict, including by disrupting supplies to European recipients. Over time Ukraine's stockpile of gas will decline and exports of Russian gas to the EU will increase, meaning Kyiv will need more and more technical gas to service the transit and this may cause it to reach for gas from transit pipelines. This would trigger a further intensification of measures undertaken by Russia aimed at discrediting Ukraine as a partner in gas relations. Russia would also use any possible problems in gas supplies to the EU as an additional argument in applying pressure on the European Commission to make decisions regarding the OPAL gas pipeline and the South Stream project that would be favourable to Russia. The divergent objectives and interests of both parties and the high stakes in the dispute (i.e. the future model of gas relations between Russia and Ukraine that will also have implications for Russian-EU energy co-operation) mean that the ongoing conflict is likely to be in place long-term.