Analyses OSW

CENTRE FOR EASTERN STUDIES 15.04.2015 www.osw.waw.pl

Gazprom's tactical concessions to Ukraine

Szymon Kardaś, Tadeusz Iwański

On 1 April, Russia and Ukraine extended the so-called winter package – the agreement on Russian gas supplies to Ukraine from November 2014 to March 2015, which was agreed last autumn as a result of the EU-Russian-Ukrainian gas negotiations – until the period of April-June 2015.

This deal must be seen as favouring Ukraine. It offers an attractive price for gas from Russia, and the agreed purchase conditions do not weaken Ukraine's position in its dispute with Gazprom which is currently before the Arbitration Tribunal in Stockholm. In the next quarter, Kyiv's main problem will not be a shortage of gas, but rather a lack of funds to purchase it. Therefore, the deadline to start filling the underground gas storages and the final level they reach will depend on Ukraine's financial capabilities.

Moscow's consent to extend the winter package represents a concession to Ukraine. The decision is primarily due to Gazprom's difficult economic situation and the failure over recent months of Moscow's gas policy towards Ukraine, which imports a significant amount of gas through the so-called reverse from Western Europe, and has reduced its consumption due to the recession and the introduction of energy-saving programmes. As a result, Moscow faces a strategic dilemma on how to proceed with its energy policy towards Kyiv.

The 'new' agreement ...

The European Commission proposed an extension to the winter package in March. The agreement signed on 1 April by Gazprom and Naftogaz is a further technical addendum to the Russian-Ukrainian gas contract of 2009. It assumes that the price of Russian gas for Ukraine in the second quarter of 2015 will not exceed US$248 per 1000 m³; this value is derived from the application of the pricing formula provided for in the 2009 contract with regard to the US$100 discount granted by the Russian government (which issued a decision in this case on 31 March). Gazprom also agreed to extend the decision, taken as part of the winter package, to suspend the implementation of the take-or-pay formula (which requires the recipient to buy an appropriate amount of gas) in the second quarter of 2015.

... and its importance for Ukraine

The signing of the agreement should be considered a success for Kyiv, as it does not demand any additional concessions from Ukraine; excludes the application of the take-or-pay clause, which Kyiv has repeatedly criticised; and allows it to purchase as much Russian

gas as it wants. Another benefit for Ukraine is the price agreed upon for the gas, which on average is US$30 per 1000 m³ less than the price of gas imported via reverses from Slovakia, Poland and Hungary. Although Kyiv has repeatedly criticised the mechanism for discounts (an administrative decision by the Russian government to amend the duty rate), it seems that negotiating a change to the mechanism was impossible. Because of the attractive April prices, Ukraine has returned to buying Russian gas, importing 60 million m³ in the first ten days of the month. The highest, stable level of gas transit via Slovakia (38 million m³ per day) has also been maintained, although deliveries via Poland and Hungary are characterised by high daily volatility in the quantity of gas transmitted. Kyiv also remains ready to import yet more supplies from the West, including the so-called large reverse from Slovakia (up to 30 bcm annually, via the Brotherhood gas pipeline); it has also started talking about deliveries via Romania. Kyiv has taken advantage of the decreased current demand for gas, connected with the end of the heating season, to fill up the underground storages. According to data from Ukrtranshaz, from 1 to 10 April 100 million m³ of gas was pumped into them; in the coming days, the daily filling rate is planned at 40 million m³. At the same time, the signing of the agreement means that in the light of the current decreasing levels of gas consumption in Ukraine (due to the economic recession, austerity and drastic price increases for individual customers) and increasing opportunities to purchase gas from Europe, the main problem for Ukraine is not a shortage of gas, but rather a lack of funds to purchase it.

The agreement does not resolve the question of Russia's 'voluntary' supplies of gas to the separatist-occupied territories in the Donbas. There is no data which would confirm either the declared Russian supplies to these territories (which are carried out via transfer points unsupervised by Ukrainian officials) or supplies from Ukraine. The Ukrainian side maintains that it will not pay for gas whose supply has not been agreed on. It is therefore expected that this issue will reappear in the Ukrainian-Russian gas negotiations, and will be raised by both parties in order to achieve their own ends.

The reasons for Moscow's conciliatory attitude

Russia's agreement to extend the validity of the winter package to the second quarter of 2015 (in particular the renewal of the gas discount) represents a concession to Ukraine.

Firstly, Moscow's decision is a consequence of the rapidly deteriorating economic indicators of Gazprom, whose financial health depends heavily on the export of gas (in 2014 Gazprom's net profit decreased by about 70% compared to the previous year, from 628.3 bn to 189 bn roubles). The company suffered losses not only as a result of a drastic reduction in its supplies to Ukraine (in 2013 Naftogaz brought around 25 bcm of gas from Russia, but in 2014 the figure was only 14.5 bcm, which reduced Gazprom's income by around US$4-5 billion, based on a price in the range of US$378-485 per 1000 m³), but above all in connection with lower deliveries to EU customers compared to previously reported nominations (the shortfall in deliveries reached around 16.5 bcm). This reduction of gas supplies to Europe was aimed at limiting reverse gas supplies from the EU to Ukraine, and Gazprom's costs due to its failure to meet its contractual obligations to European customers are estimated at US$5-6 billion.

Secondly, the concession is a result of the ineffectiveness of Moscow's gas policy towards Ukraine in recent months. Contrary to Russian calculations (during the period November 2014–March 2015, representatives of the Russian authorities and Gazprom repeatedly emphasised Ukraine's financial problems and the security risk of sending Russian gas to the EU via Ukraine), Kyiv succeeded in complying with all the provisions of the so-called winter package. Ukraine's attitude was not affected by Gazprom's launch in February of direct gas supplies to the Donbas. Russia has failed to block Western reverse gas supplies to Ukraine, despite a significant reduction in supplies to European customers. Most probably the Russians decided that if they opposed the EU's proposal to temporarily extend the winter package, this would harm their negotiating position within the trilateral Russia-Ukraine-EU talks on a new gas agreement.

Thirdly, it is possible that Moscow's conciliatory attitude is aimed at ensuring that Gazprom can strengthen its position in talks with the European Commission on obtaining the right to use 100% of the OPAL pipeline (a land extension of the Nord Stream pipeline, of which Russia currently uses about 50% due to the limitations of EU energy law). On 13 April, the Russian energy minister Aleksandr Novak said that the Russian side has initiated a new procedure in this matter.

Fourthly, the agreement concluded emphasises the binding provisions of the 2009 contract, which for Moscow is particularly important in the context of the dispute between Naftogaz and Gazprom before the Arbitration Tribunal in Stockholm, which has been ongoing since last June (and includes a request by Ukraine for a comprehensive amendment to the provisions of the 2009 gas contract).

Kyiv's next steps ...

This latest agreement is only temporary in nature. Kyiv will therefore work to continue the talks in the trilateral formula (Ukraine-Russia-EU), because the Ukrainian government's aim is to extend the validity of the current, favourable rules at least until the end of the next heating period (April 2016), and at most until the International Court of Arbitration in Stockholm hands down its judgement, which is expected in autumn 2016. Any decision to start large purchases of gas from Russia in order to fill up the underground storages (5-6 bcm, in order to reach the declared target level of 18-20 bcm by October) will depend on Ukraine's financial abilities. The issue of aid from Western creditors was discussed during the trilateral gas talks in Brussels on 20 March; last week Andriy Kobolev, the head of Naftogaz, once again asked for appropriate aid to the tune of US$1.5 billion. The Ukrainian government is hoping that oil prices will continue to fall; that the price of gas will be lower than it is now in the third quarter of this year; and that the granting of loans for the purchase will be considered favourably, so Ukraine can sign a deal to obtain significant gas supplies from Russia. Although Kyiv's calculations on the future price of Russian gas are not unfounded, according to the provisions of the Ukrainian-Russian contract a discount of US$100 per 1000 m³ can only be granted if the market price of gas exceeds US$333 per 1000 m³. If the price of gas falls below this level, as is likely, the discount for Ukraine may be lower, which would pose a threat to the resumption of negotiations on prices.

... and Moscow's

There are many indications that the failure of Russia's gas policy towards Ukraine in recent months has raised a conceptual dilemma among Russian policymakers on what further action to take (on 10 April, Moscow withdrew from the trilateral Russia-Ukraine-EU talks scheduled for 14 April in Berlin, and Vladimir Chizhov, the Permanent Representative of the Russian Federation to the European Union, suggested that they would only be resumed in June).

On the one hand, Moscow has sent signals indicating a willingness to de-politicise bilateral energy relations, as evidenced by both its consent to extend the winter package, and recent statements by Russian government representatives; on 8 April, at a meeting with the CEO of Gazprom Aleksei Miller, President Putin spoke in favour of purely business gas cooperation with Ukraine, based on the marketisation of the price mechanism; and also conceded the possibility of suspending the operation of the take-or pay-clause until the end of 2015. Russia has also declared its readiness to conclude an interim agreement resolving the issue of Russian gas supplies to Ukraine until the Arbitration Tribunal issues the award. The initial proposals formulated before the new round of gas talks indicate that Russia will try to force Ukraine to purchase the appropriate amount of gas to fill its storages; this is intended to ensure the secure transit of Russian gas to the EU during the next heating season. It is very likely that Moscow will seek to ensure that the European Union is the political and financial guarantor of such a solution, as indicated by the joint communiqué adopted after the trilateral Russia-Ukraine-EU talks held in Brussels on 20 March (in which Ukraine agreed to consider buying the required amount of gas, and the EU agreed in turn to undertake its best efforts to help Ukraine in finding the adequate financial support to purchase gas).

On the other hand, Moscow has consistently rejected the possibility of revising the Russian-Ukrainian contract by means of negotiation (a common practice accepted by Gazprom in its relations with other trading partners, in particular the EU). It is also continuing its campaign to discredit Ukraine as a transit country (during a speech in Berlin on 13 April, Gazprom's CEO called Ukraine the weakest link in the EU-Russian energy relations, with unimaginable potential for conflict), and has announced that Russian gas transit via Ukraine will cease completely in 2019.

Although prospects for resolving the strategic dilemma are currently unclear, it is very likely that internal and external factors will force Moscow to further moderate its energy policy towards Kyiv. At the same time, considering the current state of Russian-Ukrainian relations, in which Russia has often used gas supplies as an instrument to put political pressure on Ukraine, it seems unrealistic to expect the full economisation of energy cooperation between Moscow and Kyiv in the coming months.