

Ukraine: successful diversification of gas supply

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The geographical structure of gas imports to Ukraine in 2015 confirms that Kyiv has succeeded in reducing its dependence on Russia. Whereas in 2014 Russia's Gazprom supplied 14.5 bcm of gas, and 5.1 bcm came from the EU, in 2015 the proportions were reversed: the EU supplied 10.3 bcm, and Russia 6.1 bcm. This change is the result of effective action to increase the opportunities to import gas via reverse connections with EU member states, mainly Slovakia, as well as the favourable situation on the European gas market. Another reason is the decline in gas consumption in Ukraine, by about 22% last year, caused by the economic crisis and the loss of control over part of the Donbass. Kyiv has also benefited from warmer winters and the reduction in global gas prices. As a result, the winter of 2015/16 may be the first when Ukraine does not buy any gas from Gazprom, and succeeds in completely meeting its needs from Western imports and its own extraction (20 bcm in 2015). Although Kyiv has effectively reduced its dependency on gas from Russia, the authorities will have to take further measures to achieve a sustainable effect, including the further development of infrastructural connections with Ukraine's EU neighbours.

The reasons for the success of diversification

As recently as 2012, Ukraine imported almost no gas from the EU and was fully dependent on supplies from Russia. The prices for gas from Gazprom, pre-imported in quantities of 50-60 bcm per year, were rising steadily, and Moscow refused to renegotiate the gas contract from 2009, which was unfavourable for Ukraine. In 2012 this situation caused Kyiv to make its first efforts to diversify its supply lines. These activities increased in 2014 after the Euromaidan, the annexation of Crimea and Russia's military intervention in the Donbas, whereupon Kyiv demanded a revision of the contract and lower prices, refused to pay off its debt (which Gazprom estimates at close to US\$4.5 billion) and initiated proceedings before the Arbitration Court in Stockholm. Kyiv's attitude was unprecedented, and is an expression of its real efforts, for the first time since 1991, to break its dependence on gas from Russia. As a result, Ukraine has managed to reduce the share of natural gas coming from Russia in its total gas imports, from 92% in 2013 to 37% in 2015.

The success of Ukraine's gas policy is based on the following factors:

1. **An increase in the purchase of gas from the West via reverse connections.** In 2013, Kyiv bought 2.1 bcm of gas from the EU; the next year it doubled the quantity, by using infrastructure connections with Slovakia and Poland. Last year was a watershed moment, thanks to a significant increase in the capacity of the reverse connection with Slovakia, from 9.5 billion to 14.5 bcm per year (which was the result of cooperation with Brussels and

Bratislava), as well as an oversupply of gas onto EU markets. Technically, this was mainly Russian gas bought from Western companies, although it was periodically more expensive than gas sold by Gazprom. Ukraine also imported significantly smaller quantities of gas via Poland (as of 2012) and Hungary (as of 2013). In 2015, Naftogaz purchased 0.1 and 0.5 bcm of gas in these countries respectively, at the maximum capacity of these connections of 1.5 bcm and 6 bcm respectively. Kyiv is also continuing its efforts to further increase gas imports from the EU by launching supplies via the Brotherhood pipeline, a major transit route for Russian gas to the West (which could potentially supply up to 30 bcm per year).

2. The fall in consumption. In 2015 gas consumption in Ukraine fell to 33.8 bcm, from 42.6 bcm in 2014 and 59.3 bcm in 2011. The main reasons for this were the effective loss of the most industrialised part of the Donbass, as well as the general collapse of the Ukrainian economy (Ukraine's GDP shrank by about 10% in 2015). In addition, as a result of pressure from the IMF and the EU last spring, Kyiv implemented the first of three planned stages of raising gas prices for individual recipients, the aim of which is to marketise payments and reduce the state company Naftogaz Ukrayiny's deficit (7% of GDP in 2014). Kyiv also adopted a fundamental law concerning the natural gas market, of which one of the objectives is to depoliticise Naftogaz and transform it into a transparently managed and profitable corporation.

3. Financial cooperation with the West. At present, the challenge is not so much the availability of gas on EU markets, as Ukraine's limited resources to buy it. Last autumn Ukraine received international loans, including from the European Bank for Reconstruction and Development (US\$300 million) and the World Bank (US\$520 million) for the purchase of gas, which in January this year allowed Kyiv to prepare a contract to buy 1.7 bcm of gas from the EU at US\$188-212 per 1000 m³, and to choose its suppliers, mainly from Western Europe.

4. A reduction in purchases of gas from Russia. The fall in gas consumption, and the ability to reverse gas from the West, allowed Ukraine not only to significantly reduce, but also periodically to halt its purchases from Russia in 2014 and 2015. As a result, the share of natural gas coming from Russia in total gas imports fell by more than a half, and the relatively warm winters of 2014/15 and 2015/16 reduced the level of gas offtake from underground tanks. As of 1 February there is 11 bcm of gas in these reserve tanks, about 19% more than a year earlier, and Kyiv has announced that it will resume purchases from Russia only at better prices (i.e. lower than the EU's).

The end of gas dependence on Russia?

The success of Ukraine's gas diversification is a result of the actions taken by the government, the favourable economic situation, and financial and political support from the West. Kyiv has succeeded, above all, in getting reverse deliveries from Slovakia, without which its room for manoeuvre in relations with Gazprom would have been very limited. However, only implementing one of a number of planned projects –increasing the capacity of the gas pipeline with Slovakia or supplies from Hungary, or the construction of a connector with Poland (5-8 bcm per year) – would allow Kyiv to completely give up receiving supplies from Russia. Despite a drop in gas consumption of 30% over the past two years, Ukraine still has huge potential for further reductions through the implementation of

austerity measures (the Ukrainian economy's energy intensity is about 3-4 times higher than that of EU countries).

At the same time, the success of the diversification is also due to factors unconnected to Kyiv's actions, which raises the question of how long this success will last in the event of any change in the current favourable conditions for Ukraine on the European market. Positive phenomena for Kyiv include the fall in prices for oil, and thus of gas, as well as the warm winter. As a result, even Ukraine's limited financial resources have allowed it to purchase the quantities of gas it needs, and its infrastructure connections have allowed supplies from Russia to be restricted to a secure level of 4-5 bcm per year.

However, low activity in the field of stimulating energy savings, as well as the lack of a coherent concept setting the state's priorities for energy policy, including in the field of diversification, are disturbing signs. At present it seems that Kyiv has not committed to totally abandoning supplies from Russia, but is instead hoping to choose the cheapest offer available. The question also remains of the drop in Ukraine's domestic extraction, which decreased by 3% during 2015 to 19.9 bcm (although Kyiv expects a reversal of this trend next year, as a result of a reduction in fees to exploit local sources of natural gas). Despite the undeniable successes Ukraine has achieved on the road to gas independence from Russia, achieving sustainable change will require consistent and transparent action in these areas, as well as the expansion of infrastructure connections, and a fight against corruption in the energy sector.