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COMMENTARY

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Russia-Ukraine Agreements on Black Sea Fleet Stationing and Preferential Gas Prices

by Jarosław Ćwiek-Karpowicz

The extension till 2042 of the term of the Black Sea Fleet's stationing in the Crimea in return for preferential gas prices increases Ukraine's political and economic dependence on Russia. This decision of President Viktor Yanukovych is due to the state's economic plight and it evidences the powerful clout of the industrial lobby which has a stake in the continued inflow of subsidies to Ukraine's energy-intensive economy.

During President Dimitry Medvedev's visit to Kharkov on 21 April, Russia and Ukraine agreed to extend the lease of the Black Sea Fleet's base in Sevastopol in the Crimea for 25 years, relative to 2017 when the lease in effect was due to expire. The parties also agreed that the parliaments of the two states would ratify the agreement concurrently. The agreement on the lease of the base was directly linked to gas negotiations. Representatives of Gazprom and Naftohaz signed, in the presence of the presidents of the both states, an annex to the ten-year gas contract signed last year. The annex provides for a discount to be granted to Ukraine on Russian gas, of 30% if the benchmark price is $330 per 1,000 cubic meters (tcm) or less, and of $100/tcm if the benchmark price shoots past this mark. The Ukrainian side undertook to purchase at the new price 30 billion cubic meters of gas by the end of this year (which will bring its gas imports to a total of 36.5 bcm) and to take as much as 40 bcm in 2011. President Yanukovyvh estimates that the discount will save Ukraine some $40bn over the next 10 years. Both the pricing formula indexed to the prices of oil and petroleum products and the "take-or-pay" rule both remain unchanged.

Since his victory in the January presidential election Viktor Yanukovych has worked towards delivering on one of his main campaign promises, which was to have the price of gas imported from Russia reduced. In 2010 Naftohaz has been paying one of the steepest rates in Europe, of $305/tcm in the first quarter and in $330/tcm in the second quarter (when in Europe the selling price of gas averaged $280/tcm). The high price of this energy resource has threatened the interests of the Ukrainian industrial lobby, which has a stake in subsidies for energy-intensive production. Also, the costly gas has been destabilizing the state's financial situation by inflating budget spending on the settlement of Naftohaz's commitments. Last but not least, problems with the 2010 budget were an impediment to the continued lending by the IMF to Ukraine. Yet, although the discount on gas will enable the government to balance the budget, it will not solve the structural problems of the Ukrainian economy. Indeed, it could even sap the authorities' motivation to introduce necessary reforms.

From Russia's perspective the extension of the lease is an important geopolitical advantage. It improves the situation of the Russian minority in the Crimea, makes Ukraine's NATO membership a more remote prospect, and it bolsters Russian influence in the Black Sea region. When applying energy policy instruments to achieve a strategic goal the authorities decided that the financial losses incurred in the gas discount would fall on the federal budget rather than directly on the Russian supplier (Gazprom). Accordingly, the gas sold under the new arrangement will carry no export duty (the value of which matches that of the discount). The shortfall in budget receipts will be partly offset by reduced payments for the lease of the Black Sea Fleet's Crimean base. As for Gazprom, with more gas to be delivered to Ukraine and the with the existing formula for calculating the benchmark price remaining in effect, it is ensured a stable and fairly predictable level of receipts in the next ten years. Such certainty is important now that the external environment is changing in the wake of the progressing liberalization of the EU gas market and of the liquid gas glut caused by the soaring growth of "shale gas" production in the US.