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The Gas Market in Ukraine: The Main Challenges and Possible EU Actions

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The double increase of the price of Russian gas for Ukraine in the past few days, re-opens the discussion on the state of the Ukrainian gas sector and the possibility of settling the country's debts to Gazprom. First of all, Kiev's budget woes represent the greatest risk to the continuation of Russian supplies. At stake in this case is not only the energy security of Ukraine, but of the European Union itself, as more than half of gas imported from Russia passes through Ukraine. The EU may minimise the risk of a transit crisis by offering Ukraine conditional financial assistance, including the modernisation of its gas industry, and by promoting alternative routes for the EU's gas supplies.

As of the end of March, the preferential price for natural gas Gazprom had offered Ukraine for the first quarter of 2014 was eliminated. The discount to $268.50 per 1000 m3 was a political gesture from Russia to former Ukrainian President Viktor Yanukovych in exchange for not signing an Association Agreement with the EU. As the situation has changed in Ukraine, starting from 1 April the price was to be $385.50, then two days later, Russia raised it by another $100 (to $485). The increase is due to the termination of the agreement by Moscow from 2010 on the stationing of the Russian Black Sea Fleet in Crimea, in return for which Naftogaz received a 30% discount on gas prices. Russia says it may demand further compensation for losses in terms of tariffs and transmission charges. In real terms, this means Moscow has returned to the original rules set in an agreement concluded on 19 January 2009, which set a base price at $450 per 1000 m3, and market prices for various oil products.

Ukraine's Gas Market. Natural gas is the most important energy source in Ukraine's energy mix, at about 40%. With consumption in 2013 at 50.4 bcm, Ukraine is one of the biggest consumers in Europe. Although gas consumption has been decreasing (in 2013 by 4.4 bcm), nevertheless around 23 bcm is consumed by industry and electricity production, 16 bcm by households and the public sector, and nearly 9 bcm is used by heating companies. While industry pays for the gas at market prices, individuals and heating plants benefit from budgetary subsidies, with on average Ukrainian households paying only around 20% of the price of the imported gas. These subsidies altogether amount to 7% of GDP and increase the country's budget deficit. The artificially low gas prices and the dominance of traditional and energy-intensive industries in the Ukrainian economy (steel, chemical production) result in the high demand for gas, and very low energy efficiency has further exacerbated the problems.

More than 60% of the gas consumed in Ukraine is imported, and almost all from Gazprom (in 2013, about 26 bcm). Imports from EU countries via German firm RWE Supply & Trading through reverse flows from interconnections with Poland and Hungary play a small role—2.1 bcm. Domestic production in 2013 amounted to 20.4 bcm. Considering its large degree of dependence on Russian supplies, Ukraine intends, within 10 years, to increase gas production to 30 bcm, including from shale gas, and international oil companies (Chevron and Shell) are interested in this sector. The Ukrainian authorities, however, have yet to formally seek to diversify supplies, as a project to build an LNG terminal in Odessa has been delayed, as have new connections with the EU or the possibility of importing gas from Azerbaijan, and Ukraine may lose access to rich gas deposits in the Black Sea.

The Main Problems. The key challenges for the Ukrainian gas sector is its excessive dependence on Russian imports and highly unfavourable supply contract with Gazprom. Although, in 2013 Ukraine has decreased yearly imports from Russia by 15%, according to Ukrainian transmission system operator Ukrtransgaz, and in 2014 aims for a further reduction, it is formally inconsistent with the applicable contract. The agreement concluded in January 2009 obliges the Ukrainian side to purchase 41 bcm of gas per year, with a take-or-pay clause and a prohibition on re-export. In practice, it prevents the effective diversification of supplies.

The contracted gas price for Ukraine is among the highest in Europe, while prices paid by consumers of Naftogaz are the lowest. Naftogaz bears the very high costs of purchasing the gas while, at the same time, the low prices paid by consumers means it cannot rely on an equal return from its customers. In addition, on sales to industrial customers, Naftogaz must compete with Ostchem Holding—a company belonging to oligarch Dimitri Firtash—which fiercely competes with the state-owned company. In 2012, Ostchem Holding negotiated a lower price with Gazprom ($260) and took over sales to key Naftogaz customers (chemical industry). In 2013, Ostchem's imports from Russia caught up with Naftogaz (each importing 12.9 bcm). The state-owned company's debt to Gazprom amounts to about $2 billion, limiting resources for necessary investment and affecting liquidity.

Another problem is the very structure of the Ukrainian gas market. Naftogaz is responsible for production, distribution and transport, and owns gas pipelines and the transmission system. This organisation of the sector is uncompetitive and non-transparent. Although Ukraine has committed itself to reforms by introducing industry unbundling according to rules under EU energy law when it joined the Energy Community in 2011, plans for the privatisation and restructuring of Naftogaz have not been implemented. The lack of transparency in the sector promotes fraud and strengthens business ties to oligarchs within the political structures.

In the Spirit of Solidarity. The most important issue now is financial aid. Without that, Ukraine will not be able to pay its current bills for gas, settle its debt with Gazprom, or reform or modernise the sector. The lack of a reckoning on the gas from Russia poses a real threat that Gazprom would stop deliveries, which would result in very serious economic and social consequences. Ukraine is a major transit route for Russian gas (82 bcm out of 155 bcm in 2013), and therefore at stake is not only Ukraine's but also the EU's energy security. European Commissioner for Energy Günther Oettinger said that part of the EU aid would be used to repay this debt. The EU should provide financial guarantees to the government of Ukraine and to offer assistance in negotiations with Gazprom to restructure that debt.

Also key for the gas sector in Ukraine is the modernisation and development of infrastructure. Apart from the European Commission, the European Investment Bank, the European Bank for Reconstruction and Development and the World Bank should be involved in the process. The fundaments for cooperation were already defined in a joint declaration on the modernisation of the Ukrainian gas transport system in March 2009. Since vast amounts of money will be involved, these institutions should keep an eye on transparency to avoid the misuse of funds.

The EU, after two previous gas crises when it took measures to increase its internal security of supply, should extend this experience to Ukraine. Obviously in the current economic situation, gas market reform in Ukraine is not a priority, in the long run the EU should make sure that the model for reforming the country's gas sector is based on the EU regulatory framework and market liberalisation. This stems from the Energy Community Treaty, which Ukraine signed in 2011. In the near future, alternative supplies from the EU to Ukraine will be of utmost importance. These would allow for ongoing assistance in the event of supply disruptions, and in the longer term as a means to reduce dependence on Gazprom.

The EU should engage in promoting reverse connections with Ukraine by including them on the list of EU projects of common interest. However, this does not ensure diversification of supply, even with planned imports from Slovakia of up to 10 bcm of gas per year. But in the event of a disruption of deliveries by Gazprom to Ukraine, the bloc's ability to send gas would be limited due to a lack of internal sources. Therefore, the balance of the Ukrainian demand will be met neither by EU exports nor by increased domestic production, or even the use of gas stocks (which are currently at a very low level in Ukraine). In the short term, the only real solution may be an immediate return to the concept of a floating LNG platform in Odessa, which according to the original Ukrainian plans would allow for up to 5 bcm of imports. The EU, with the U.S., should offer support to accelerate the implementation of the investment, and advise leasing the terminal.

EU actions in its relations with Gazprom, including the consistent application of the provisions of the third energy package for two Russian investments, will be crucial for the North European Gas Pipeline (especially the German branch of OPAL) and the South Stream pipeline, which will allow gas to bypass Ukraine and will reduce its transit role. The EC should comply with the conditions for an exemption from EU law, insist especially on the requirement that the investment increase competition for gas supplies and security of supply.

The EC must also demonstrate determination in antitrust proceedings against Gazprom, the outcome of which depends on whether adverse rules would be maintained to purchase Russian gas. Ejecting such clauses from contracts with EU customers will increase the bargaining position of Ukraine. To encourage spill-over benefits (lifting the ban on re-exports, relaxation of the take-or-pay clause, more competitive prices), the EU should be engaged as a mediator in future Russian–Ukrainian gas agreement negotiations or offer technical support in any case taken for international arbitration.