No. 41 20 May 2008

russian analytical digest

www.res.ethz.ch www.laender-analysen.de/russland

GAZPROM'S FOREIGN ENERGY POLICY

DGO | Research Centre for East European Studies, Bremen | CSS ETH Zurich Center for Security Studies, ETH Zurich | Otto Wolff-Stiftung

Analysis

Gazprom's Perspective on International Markets

By Tatiana Mitrova, Moscow

Abstract

Gazprom's strategy towards markets abroad has stirred debate in the Western press about Russia's foreign policy intentions. This article rebuts conventional Western views about Gazprom and Russian foreign policy in general. It argues that Gazprom's strategy of expansion is not based on political considerations, but largely follows an economic logic. Since about 2002, the company's declared aim is to transform itself from a natural monopoly into one of the world's leading global energy companies.

Role of Gazprom in International Markets

Gazprom is today not only Russia's biggest state-owned company, but also the largest gas company in the world. According to British Petroleum estimates, Gazprom possesses about 16.5 percent of the world's gas reserves and produces over 19.4 percent of the total world output. Gazprom is responsible for more than 84 percent of gas production in the Russian Federation. Moreover, it owns all export and major trunk pipelines and has the sole right to ship gas to international markets.

At present Gazprom supplies natural gas to many European countries (including the largest buyers of Russian gas: Germany, Italy, Turkey and France) and is also a key supplier of gas to Eastern European and CIS states (see Diagram 1 on p. 13). No other company exports more gas than Gazprom: According to Gazprom figures, 2006 sales to Europe reached 161.5 billion cubic meters (bcm), and sales to the CIS and Baltic States amounted to 101.0 bcm. The rest (316 bcm or about 54.6 percent) was consumed on the Russian domestic market.

Gazprom's New Strategy: From Big Pipe to Big Business

With the appearance of new markets in the Asian-Pacific region, the sharp increase of oil prices and the shaping of a new regulatory framework in Europe, the environment for Russian gas sales changed considerably during the past years. These changes have demanded a change in Gazprom's approach from a policy of "big pipeline" to a policy of "big business."

Gazprom overcame the slump in gas production experienced shortly after the collapse of the Soviet Union and, by the end of the 1990s, successfully made the transition from a Soviet ministry designed to fulfill "gross plans" into a heavyweight on the world market. Once it was clear that there would be no restructuring or even break up of Gazprom, the Gazprom management was confident enough to start developing a new foreign strategy in line with the changes on the international markets. These changes meant in the first place adapting a new sales market structure, which included a much more active expansion strategy into downstream markets. Gazprom's new strategy also included the expansion of its production base. Given that all its major fields were mature and declining, it was necessary to develop and commission new greenfield projects in remote areas of Russia.

Establishing new centers of production in inhospitable territory demanded massive investment and new technology, meaning that Gazprom had to develop a totally new approach – namely, to make the leap from being a state natural monopoly into a global company, based on the same operating principles as Exxon, BP, Chevron or Shell. The key changes included: broadening and diversifying the company's businesses (to include not only gas, but to expand into oil, coal and power), implementing internal structural reforms, beginning to make asset swaps with foreign partners, and selling shares on the open market. The latter action attracted considerable attention and led to a dramatic increase in capitalization, though by law the government owns a majority of the stock so it is impossible to radically change the ownership structure.

As regards Gazprom's strategy towards foreign markets, the most important elements defining the move from the old export strategy of "big pipeline" to the new "big business" model can be summarized as follows:

- While the old strategy focused on one external market (Europe), the new strategy aimed at diversifying exports, particularly to the Asia-Pacific region.
- While the old strategy was geared towards maximizing gas volumes, the new strategy aimed at maximizing profits.
- While the old strategy relied only on indigenous resources, the new strategy aimed at increasing Central Asian gas imports and transit and also grad-

ually expanding into production beyond the former Soviet Union.

- While the old strategy was characterized by the two principles "no foreigners in production" and "sales on the border," the new strategy envisages the upstream and downstream integration of Russian companies in the international gas business, and in particular the participation in gas production activities in Central Asia and other regions.

In the following sections, we provide an overview of how Gazprom is implementing this new strategy in the individual regional markets.

European Market

Western Europe is the major external market for Russian gas. Gazprom supplies around one-third of Western Europe's aggregate gas imports (see Diagram 2 on p. 14), typically under long-term contracts. In 2006 and 2007, a number of Gazprom's key European partners, including Gaz de France, E.ON Ruhrgas, Wintershall, ENI, and others, renewed their contracts for up to 20 or even 25 years.

Unlike in the past, gas is not only supplied "up to the border," but is directly supplied to European costumers. European gas trading houses, established in importer countries through joint ventures with Gazprom, serve as traders. Through these joint ventures, Gazprom has over the past ten years successfully expanded its presence in Europe's gas consumer market.

The key market and hub for Gazprom's sales to Europe was, and remains, Germany. As far back as 1990, Gazprom established a joint venture with Wintershall (which is a subsidiary of BASF AG for the energy market) and through the establishment of the joint companies Wingas, which is a pipeline transportation company, and the WIEH trading house, it gradually managed to enter other European markets. As a result of these joint projects, Gazprom began selling gas directly to consumers in Germany and obtained much larger profits than under the previous system, when gas was sold at the border. Moreover, through the Wingas gas transportation system, which is now over 2,000 km long, Gazprom is able to supply natural gas not only locally within Germany, but also to Germany's neighbors (see Map 1).

Gazprom has also established itself firmly in Austria. Already in 1991, thanks to the establishment of the Gas- und Warenhandelsgesellshaft mbH (GWH) company on a parity basis with OMV AG, Gazprom's share in the local market reached 78 percent. The GWH also provides for transit of one quarter of Gazprom's European supply. Gazprom intends to expand its presence in Austria and to create a transport hub there for gas trading operations.

Gazprom has also strengthened its position in Italy, where – since April 2007 – the company is allowed to make direct deliveries of Russian gas to the Italian market through joint ventures with Italian companies. Already in November 2005, Gazprom obtained official authorization to sell gas to end consumers in France. Despite the strong objection of the British government, Gazprom has now also successfully entered the UK gas market, which is the largest gas market in Europe, and the most competitive one. Over the past years, Gazprom has also significantly enhanced its presence in Finland, Greece, Hungary, Bulgaria, Serbia, and several other European countries.

Gazprom views the liberalization of the European gas market as a way to expand the company's direct access to end-consumers. However, there is intense competition in this sector, and a number of countries try to counter-act Gazprom's expansion. The decision of the EU Commission in summer 2007 on strategic foreign investments is illustrative; according to the EC proposal, companies from third countries cannot acquire control over a community transmission system or transmission system operator unless this is permitted by a special agreement between the EU and the third country.

Gazprom has traditionally exported its gas under long-term contracts. However, the EU market liberalization leads to the wider use of mid- and short-term contracts, as well as spot deals. Although Gazprom is one of the most active proponents of long-term contracts (it even managed to make the European Commission revise its position and proved that such a mechanism is needed for large new projects), it is eager to use spot and short-term deals (and uses them more and more often), as well as exchange transactions (especially when selling gas to the UK).

CIS and Baltic Markets

In 2006 gas sales to the CIS and Baltic States grew by one-third to reach 101 bcm. The key customers were Ukraine, Belarus, Kazakhstan and Azerbaijan (see Figure 3 on p. 14). In 2004, Gazprom started to raise its gas prices to CIS costumers to market prices. The price changes, which Gazprom has instigated with a range of former Soviet countries, represent a paradigm shift in Russia–CIS energy relations. The conflict in Russian–Ukrainian relations coincided with a period when oil and gas prices were rising to new heights. By late 2005, the $54 per thousand cubic meters of gas which Ukraine was paying for Russian gas contrasted sharply with European border prices 3–4 times that level. The difference was too great. After 15 years of supplying Ukraine with cheap Russian gas, Gazprom and the Russian government decided that they would no longer be prepared to provide gas at subsidized prices to former allies.

As a result, gas prices for the CIS region have grown two- to threefold and are gradually reaching European levels (minus transportation costs). An important result of these difficult negotiations was that finally a clear differentiation between contracts for gas supply to Ukraine and Belarus and contracts for gas transit via their territory to Europe was achieved. The market principles of relationships are fixed in a five-year gas supply and transit contract signed with Belarus.

To many in the West, it seemed that Russia was trying to force Ukraine into accepting a gas price increase as some sort of political punishment for "moving west" after the Orange Revolution. Yet when Gazprom raised the price, it in fact eliminated the political element from its energy relations with Ukraine and put the relationship on a firm business footing. The main problem was that Gazprom failed to explain in time to its European and CIS partners its position and eventually lost the public relations battle with Ukraine, which was able to present itself as the "victim" of Russian imperial politics.

Unfortunately, the company still has to deal with the long-term adverse effect of the Russian–Ukrainian gas conflict of January 2006. The actions of the Russian side, particularly, the demonstrative closing of the valve for 24 hours, created a very negative image of Gazprom in the West. Currently, the Europeans are more determined than ever to seek alternatives to Russian gas supplies.

Russia, for its part, is building new pipelines in order to provide alternative routes for gas shipped through Ukraine, thus assuring the Europeans of its intentions to be a reliable partner. Even when these pipelines are built, however, the bulk of Russian gas will still cross Ukraine. Its existing gas transportation capacities are three times larger than any other routes being built or designed; moreover, the Ukrainian route is the shortest way to the most attractive markets. The North European gas pipeline under the Baltic Sea (the Nord Stream Pipeline), which will connect Russia and Germany directly, will be used for the additional gas volumes that Europe will need during the next decade. Meanwhile, the Ukrainian pipelines need a general upgrade, since they were built during the Soviet era. The need to update the infrastructure partly explains why Gazprom proposed the idea of creating a Russian-Ukrainian-German consortium to manage Ukraine's gas transportation system. As of today, however, Ukraine has rejected any such proposal.

Gas Imports from Central Asia

Central Asia has substantial oil and gas reserves. Yet, the obstacles to the development of the region include its remote geographical position, with no direct access to sea routes, and a lack of large gas export pipelines other than those through Russia. At the same time, foreign investments (currently concentrated mostly in Kazakhstan) may turn this region into an important center of hydrocarbon production. The Central Asian countries, in turn, will try to obtain direct access to consuming countries in Europe, for example, via a pipeline under the Caspian Sea – a project which Russia opposes vehemently.

Should the Central Asians manage to establish direct outlets for their gas and should Gazprom lose control over these energy flows, the Central Asian export resources may be sent not only to the European markets, but also to China, India and Pakistan. These resources will compete with Russian gas in each of these markets.

Central Asian gas is important for Gazprom's domestic gas balance. Controlling the flow of Central Asian gas is also important as it ensures Gazprom's continuous control over overall flows of Eurasian gas to Europe, thus ensuring that Gazprom is able to maintain its share in the lucrative European market.

Gazprom already buys almost the entire volume of gas exported from Turkmenistan, Kazakhstan and Uzbekistan (57 bcm in 2006) and has been authorized to operate the "Central Asia – Center" gas-pipeline system designed to export gas from the region to Russia. Gazprom is ready to expand purchases of Central Asian gas and upgrade the existing pipeline system. The problem is, however, that since 2003, when a fundamental agreement on energy cooperation was signed with Turkmenistan, which is the main gas producer and exporter in the region, the production volumes in this country have stagnated.

Production in the Other Countries

Due to the fairly rich resource base of the domestic gas industry, Gazprom has never been seriously interested in production projects outside the post-Soviet space. Yet the natural depletion of low-cost resources in West Siberia and the Urals has made it urgent for Gazprom to redirect some capital to prospective projects in other parts of the world. While Gazprom has shown interest in hydrocarbon production in foreign countries, the scope of these projects are so far limited.

Gazprom began this activity in 2000, when the company was involved in production projects in Vietnam and India. In December 2005, the Indian state gas distribution company GAIL together with Gazprom began exploration drilling in oil-and-gas fields located in the Bay of Bengal. Gazprom invests capital in the development of the British field in the North Sea. In October 2005 Gazprom won the bid for geological exploration and hydrocarbon field development in Venezuela. The appropriate licenses are granted for 30 years.

Over the last two years, Gazprom has shown interest in diversifying its production through an expanded presence in North Africa, the Middle East and the North Sea shelf. Gazprom is negotiating a role in oil-and-gas field development in Egypt and Algeria, as well as participation in gas projects in Libya and Nigeria. Additionally, it works with energy companies from various countries of Latin America, which were the first to enter in Gazprom's area of interest. A key aim is to enter the US gas market.

Asian Market

The EU's declaration that it wants to reduce its dependence on Russian gas (as reflected, for instance, in the EU's Green Paper) is understandable. Similarly, Gazprom is making efforts to diversify gas sales markets. If EU countries diversify away from Russia then it is only natural that Gazprom looks for ways to diversify away from the EU in order to maximize profits and to minimize investment risks related to new gas projects. Therefore, Gazprom is looking to expand its presence in Asia.

Gazprom considers the development of the eastern markets a priority. The company has signed strategic cooperation agreements with the largest Chinese and Indian oil and gas companies. In 2007, Russia adapted a program for the comprehensive development of hydrocarbon fields in Eastern Siberia and the Far East with the aim of creating a gas supply system for Russia's eastern regions and a channel for gas exports to Asia. According to this document, the top-priority steps for Gazprom in this region are the development projects for Sakhalin offshore fields, which are already being implemented or are in a state of "high readiness."

Some European experts claim that in the context of Gazprom plans to organize gas supplies to China, Gazprom will not have enough gas to provide gas to all potential markets, thus threatening the reliability of Europe's gas supply. Yet these experts fail to understand that gas supplies to China will originate in yet-to-be developed frontier gas fields in East Siberia and the Far East (Europe receives its gas from fields in West Siberia and the Urals). Deliveries from the East Siberian fields to Europe would be economically inefficient. Actually, Russia has sufficient reserves and investment potential to become a "gas bridge," supplying both the eastern and western parts of Eurasia.

Yet it is unlikely that Russian gas will enter the Asian market in the near future. The main uncertainty for Gazprom is related with volumes of future demand. China's economic growth does not look sustainable to Russia, and Beijing's energy policy priorities in the gas sector are not very clear. Moreover, the two sides have not yet agreed on a price that is mutually acceptable. There is yet another reason why Russia is reluctant to build a pipeline directly connecting Russia and China. As Russia learned from its experience with the "Blue Stream" pipeline connecting Russia with Turkey, a single buyer is in a relatively strong bargaining position to demand lower prices once the pipeline is built or else it refuses to buy the gas.

Challenges for Gazprom in Europe

Europe is and will remain Gazprom's key market. Yet there are also a number of serious challenges which Gazprom is facing implementing its new strategy of expansion. These challenges can be grouped around two issues: on the one hand, Gazprom might face serious regulatory barriers in those European countries where it currently operates; on the other, Gazprom might face serious market risks due to growing competition and unpredictable price and volume movements.

Gazprom is currently very concerned about the possibility that existing long-term contracts will be revised. Long-term agreements, which form the basis of Gazprom's business in Europe, typically contain a "take or pay" provision and assure steady gas supply and a reliable market. Long-term deals serve as a guarantee to the supplier that its multibillion dollar investments in major gas export projects will be amortized. Conversely, they ensure the steady and uninterrupted flow of gas to the consumer. In this regard, the EC's proposal of summer 2007 to separate production from transportation activities might, if implemented, also affect the stimulus for Gazprom to invest in the export pipelines.

As mentioned earlier, Gazprom has been expanding into spot market trading and plans to develop its LNG capabilities in order to react flexibly to market changes. However, if there is a radical change in the system of long-term contracts, there is a real threat that the incentives for producers to invest in new projects will be sharply reduced. Short-term contracts cannot give a guarantee that large capital-intensive projects, comparable in scale with the development of Yamal or Stockman, will see a long-term financial return.

The problems connected with attracting investments are aggravated by one additional factor – the dramatic growth of price volatility. As a result of liberalization, the uncertainty of price forecasting will increase in comparison with the traditional system of long-term contracts because significant fluctuations on spot markets will be added to the fluctuations of oil prices. Even a relatively small increase in gas supplies to the spot market may lead to price decreases, while seasonal deficits may sharply raise them. The popular belief holds that the main threat of European gas market liberalization for Russia is a decrease in gas prices as a result of stronger competition. However, the real danger for Russian exports is connected not so much with the level of prices, but mainly with growing price instability.

Europe will remain the key market for Gazprom for the foreseeable future, especially taking into account the system of export gas pipelines already built and under construction, but there are also serious risks involved in this market which Gazprom needs to take into consideration when deciding on upstream investments. Europe's demand for gas is forecasted to grow dramatically, but there are many factors that might limit this growth, namely if Europe experiences an economic recession or if energy efficiency programs are pursued more vigorously. The difficulty to predict demand rates is the more problematic for Gazprom since the company might also face much tougher competition for its sales in the future: Over the next 10–15 years the European market will see new gas suppliers from North Africa (Algeria, Libya, Egypt), Central Asia (Turkmenistan and Kazakhstan) and the Middle East (Iran), which are able to sell their gas at a relatively low price. A further problem is the development of LNG, which will slowly turn the gas market into a global market once it becomes less expensive in the future to produce LNG. All these developments would further enhance competition for Russian gas.

Gazprom's Strategy: Business Prevails over Politics

Many Western experts consider Gazprom not just a commercial corporation, but a vehicle for promoting Russia's political interests abroad. By the same token, Gazprom is often referred to as a state company of Russia, and hence, its economic initiatives are often viewed as being the political business of the state. But Gazprom, although it is 51-precent state-owned, is indeed a commercial organization and must justify its strategy and activities to its main shareholders, which consist of both state and non-state actors.

Actually, in recent years there was only one political decision about Gazprom – to make it a "national champion" of Russia. The creation of a "champion" means that it has to respect international rules and, more importantly, it has to be profitable, efficient and commercially oriented – otherwise it would never prevail in international competition. Unfortunately, the media frequently tries to find political roots in economic decisions (as happened with the Russia–Ukrainian crises). The process of transforming the former Ministry of Gas Industry (which Gazprom was less than 20 years ago) into a quasi-ministry in the 1990s, and then into one of the leaders of the international energy business (according to current plans) is necessarily evolutionary and takes time. There is a lot of work to do with the companies` management, transparency and mentality. But even now the progress is obvious.

One important implication that gives optimism is that to be successful in the global market, Gazprom will have to "play by the rules of the game" in this market. Gazprom will thus have to adapt to the same standards as other private international energy companies when operating in a globalized environment. The Western press has often criticized Gazprom for diminishing the status of foreign partners in its upstream projects in Russia to minority share-holders. Yet one also needs to take note of the fact that all of Gazprom's new export projects will be developed in cooperation with foreign companies. These joint projects include the Gazprom-ENI cooperation in Astrakhan as well as the Blue Stream and South Stream parity projects, the Gazprom-Wintershall joint venture at Urengoi, the Gazprom-Total-StatoilHydro plans for Shtokman, the Gazprom-Shell cooperation in Sakhalin-2, and the Gazprom-E. ON-BASF and Gasunie cooperation at the NEGP and South Russian fields.

This market-based mutual penetration of capitals will have a strong influence on the behavior of Gazprom. Gazprom's global activities are the best stimulus for the company to change and develop. Generally, Gazprom's presence abroad and interaction with foreign companies will force it to be more efficient and reform in order to survive and win in the international competition. As of now, however, the problem is that Gazprom's partners abroad, especially in the CIS and partly also in Europe, have a negative view of Gazprom and perceive it as an organization with a largely political agenda. It will take some years, maybe even decades, for this image to transform.

Edited by Jeronim Perovic

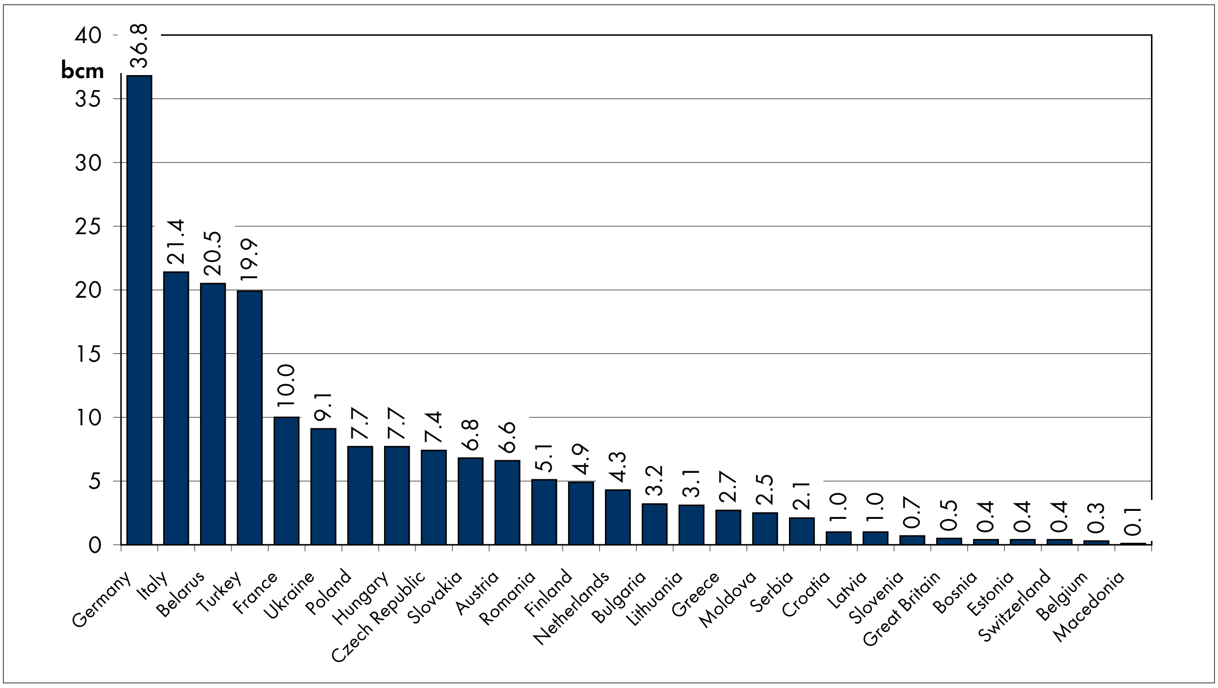
About the author

Dr. Tatiana Mitrova is head of the Center for International Energy Markets Studies at the Russian Academy of Science.

Diagrams

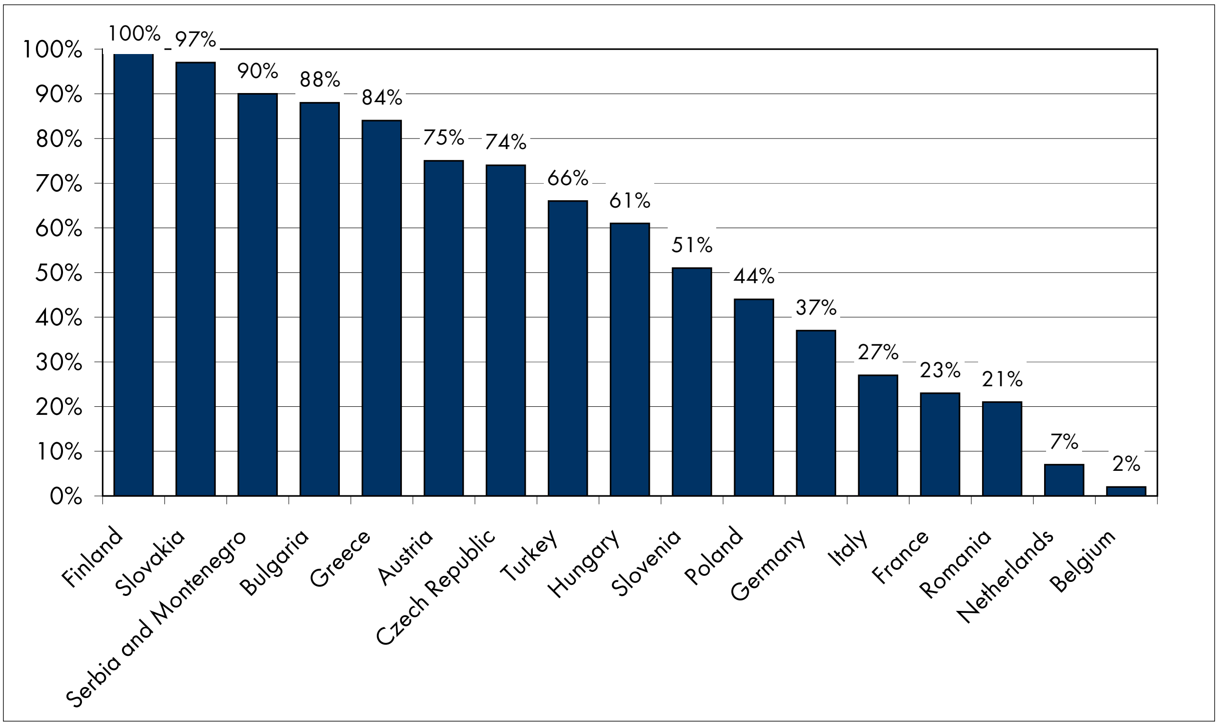
Gazprom Sales

Diagram 1: Natural Gas Export Deliveries by Gazprom to Individual Countries in 2006 (in bcm)



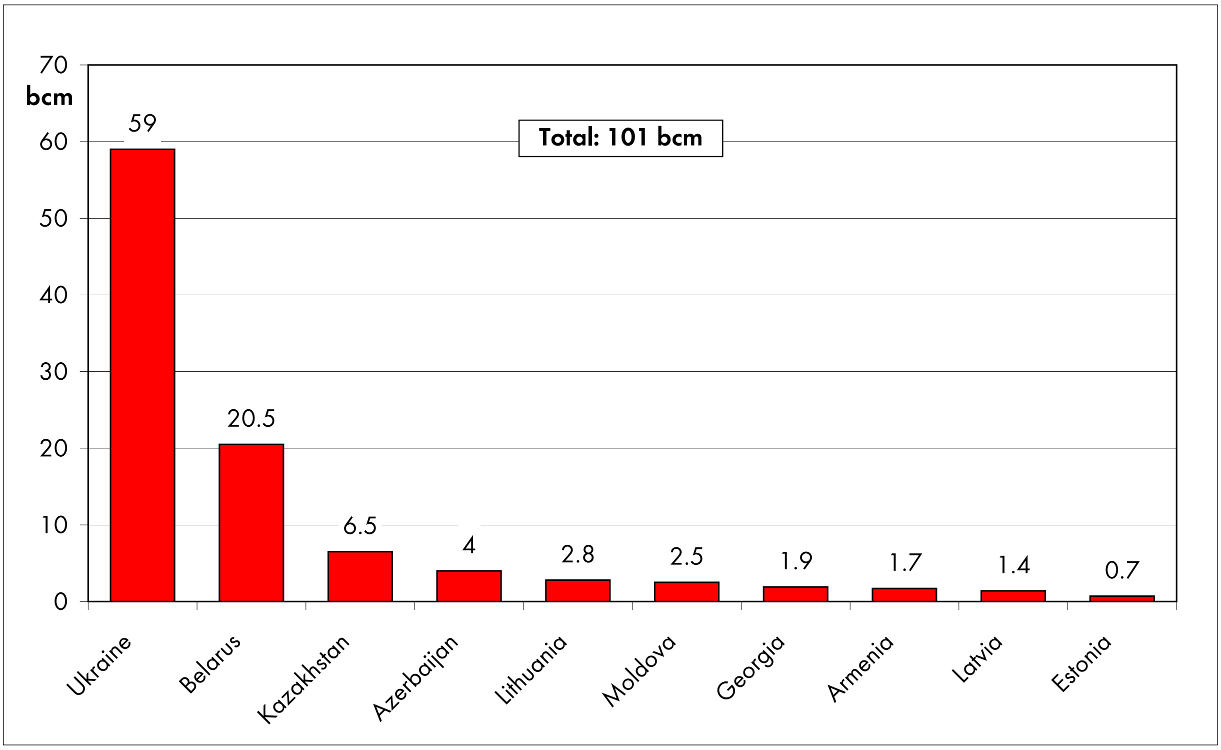
Source: Gazprom

Diagram 2: Gazprom's Shares in the European Gas Markets



Source: Gazprom

Diagram 3: Gas Sales Structure for the CIS and Baltic States in 2006, bcm



Source: Gazprom.

Analysis

The Natural Gas Conflict Between Russia and Ukraine

By Heiko Pleines, Bremen

Abstract
Ukraine depends to a large degree on Russian energy deliveries. At the same time, it is the most important transit country for Russian energy exports. The mutual dependency has created a stalemate situation and difficulties in the relations between the two countries. Compared to previous years, however, the conflict between Ukraine and Russia over the gas trade has relaxed noticeably, despite some dramatic interludes that remain. While 2006 saw a suspension of deliveries, a drastic deterioration of foreign policy relations, and a trade conflict, an agreement was reached in 2008 – albeit at the last moment – that was welcomed by all sides. The core problems remain unresolved, however.

Ukrainian Dependency
Just as during the Soviet era, Ukraine today remains dependent on energy imports from Russia, particularly oil and natural gas deliveries. Ukraine's production only covers 25 percent of its oil needs and 15 percent of its gas requirements. Since all existing oil and gas pipelines to Ukraine come from Russia, Ukraine has few alternatives to diversify its supply. Deliveries from Central Asia depend on the consent of pipeline operators controlled by the Russian state, monopolist Gazprom for natural gas and the state-controlled Transneft company for oil.

In Ukraine's complicated relationship with Russia, the trade in natural gas has proven noticeably more difficult than the oil business. There are two reasons for this difference. First, gas accounts for nearly 50 percent of Ukrainian energy use, making it the most important primary energy source. Second, Ukraine must deal with Russian gas monopolist Gazprom, whose good relationship with the Russian government gives it a strong negotiating position, allowing it to exert significantly more pressure than individual Russian oil companies would be able to bring to bear.

After the collapse of the Soviet Union, Russia began to charge Ukraine "normal" prices for energy deliveries. Dollar payments were demanded of Ukraine as early as 1992. Prices were raised incrementally. Ukraine was unable to meet its payment obligations under these contracts and found itself exposed to significant Russian pressure. In 1993, energy deliveries were drastically reduced, triggering an energy crisis in Ukraine in the winter of 1993/94. Many industrial enterprises had to cease production, public buildings were not heated, and streetlights were switched off. At this point, Ukraine's debts for Russian oil deliveries had reached US$600 million. Since Ukraine was obviously insolvent, Russia demanded shares in Ukrainian energy companies in compensation. However, Ukraine cited national security considerations for its categorical refusal to consider Russian participation in the gas industry during the 1990s.

Russian Dependency

Despite its high level of debts, Ukraine was not defenseless against Russian pressure. On the contrary, Russia was forced to accept that collection of payments receivable was only possible to a limited degree, due to the Russian dependence on Ukrainian transit pipelines for exports to Western Europe. In the mid-1990s, 95 percent of Russian gas exports and more than 50 percent of Russian oil exports to non-CIS countries passed through Ukraine. This transit trade allowed Ukraine, on the one hand, to alleviate energy shortfalls by illegally siphoning gas from pipelines. On the other hand, it could demand considerable transit fees from Russia.

An Initial Compromise

This stalemate led to the conclusion of an initial compromise in the mid-1990s. Under the agreement, Ukraine was to receive more than half of its gas imports in lieu of transit fees. Additionally, Russian leasing fees for Black Sea Fleet military bases on the Crimean Peninsula were used to repay Ukrainian energy debts. Furthermore, Ukraine aimed to repay its gas debts through barter deals, for instance through delivery of fighter-bomber aircraft to Russia. Direct cash repayments were apparently discontinued altogether. Gazprom accepted this arrangement in order not to endanger its gas exports to Western Europe. As a result, Ukrainian gas debts continued to rise.

Renewed Escalation

In early 2000, Ukraine owed Russia US$1.4 billion for gas deliveries. Gazprom demanded an additional US$700 million in interest, penalties, and refund payments for theft of siphoned gas. At the same time, Gazprom exported the first deliveries of gas through the Yamal Pipeline, which had become operational in autumn 1999 and whose route through Belarus and Poland avoided Ukrainian territory. The Russian gas corporation used the occasion to increase pressure on Ukraine once more. It aggressively pushed for a resolution of the debt issue and an end to gas thefts, while at the same time forging ahead with plans to build further alternative export pipelines circumventing Ukrainian territory.

In this way, Gazprom managed in autumn of 2002 to force Ukraine to take up negotiations on an international gas consortium that would administer the Ukrainian pipelines. In addition to Gazprom and Ukrainian partners, the negotiations also involved German gas importer Ruhrgas. However, no agreement was reached.

The Second Compromise

In the matter of debt settlement, however, progress was made. In April 2004, the sides adopted a plan that included considerable concessions to Ukraine. Gazprom reduced its repayment demands by US$200 million and accepted Eurobonds for payment of the remaining debts, with staggered payments to be made by 2013. Under an additional agreement in August 2004, the outstanding Eurobond payments were offset against Gazprom's transit fees until 2009. As a result, Ukraine had resolved its debt issues with Gazprom, but was no longer to receive gas in lieu of transit fees from 2005 onwards. Additionally, the price of Russian gas deliveries was fixed in a binding and "immutable" contract at US$50 per 1,000 cbm. This constituted a significant discount compared to the price charged for EU importers. However, this discount was largely financed by Turkmenistan, which delivered nearly two thirds of gas exports destined for Ukraine.

The 2006 Suspension of Deliveries

In autumn 2005, after the agreement to construct the Baltic gas pipeline had weakened Ukraine's leverage as a transit country, conflict broke out anew. Gazprom demanded an increase of the gas price to US$160 per 1,000 cbm from the beginning of 2006. When no agreement had been reached by December, Gazprom raised its price demand to US$230 and suspended deliveries to Ukraine at the beginning of the new year. However, it again became clear that the dependence on Ukrainian transit pipelines weakened Gazprom's position. When deliveries were stopped, Ukraine diverted gas from transit pipelines, calling the Russian action a violation of the bilateral treaty on gas supplies. As a result of Ukraine's gas siphoning, Russian supplies to the EU where considerably reduced. Pressure from the EU then forced Gazprom to resume deliveries to Ukraine.

The Current Arrangement

As early as 4 January 2006, Gazprom and the Ukrainian state company Naftohaz Ukrainy reached a provisional agreement. The price for Ukrainian gas imports was raised to US$95. At the same time, Gazprom was guaranteed a price of US$230 for its deliveries. The difference between the high price of Russian gas and the significantly lower price at which it was sold to Ukraine was passed on to the Central Asian suppliers, who were not involved in the negotiations leading to the agreement.

The fulfillment of deliveries to Ukraine was handed to an intermediary firm, Swiss-registered RosUkrEnergo, which is jointly owned in equal parts by Gazprom and private Ukrainian businesses. Ukrainian public opinion was critical of the involvement of RosUkrEgo, since the company was the subject of a public prosecution in Ukraine on suspicion of having links to organized crime and its ownership structure was opaque at the time.

The Ukrainian parliament used the opportunity of the agreement to bring a vote of no confidence against the government. At the same time, tensions continued to simmer in Russian-Ukrainian relations over matters related to the use of infrastructure on the Crimean Peninsula by the Russian Black Sea Fleet and a trade conflict focused on anti-dumping measures and import restrictions particularly for food and metal products.

In the subsequent years, the price of gas imported to Ukraine increased considerably, mainly due to price hikes and delivery shortages on the part of Turkmenistan. In 2007, the delivery price charged to Ukraine stood at US$130, and it was fixed at US$179.50 for 2008. Gazprom has announced further increases for the coming years. Within a few years, the price charged to Ukraine is to be aligned with EU prices for Gazprom's deliveries. The price Ukraine would have to pay then would be identical to that paid by EU countries, minus transport costs and tariffs. At the current pricing levels, Ukraine would then have to pay considerably more than US$200. The actual price would depend, however, on the development of global market prices for oil, to which the price of gas is tied.

The drastic price increases caused the value of Ukraine's annual gas import requirements to rise to over US$7 billion in 2007. Ukraine was now no longer able to compensate for the price hikes by increasing transit fees for Russian gas exports to the EU. While transit fees of US$1.5 billion in 2005 were sufficient to pay for half of the imported gas, the US$2 billion in fees collected in 2007 only corresponded to slightly over one quarter of import costs. If Ukraine delays payment by only a few months, the country will run up billions of US dollars in debt.

Since the state-run company Naftohaz administers the entire process of importing Ukraine's gas, it is ultimately the state budget that must pay off the outstanding debts. While the state adapts gas prices for industrial customers to increasing import prices, the supply of gas to private households is heavily subsidized. In 2006, private households paid only US$37 on average, while the import price had already climbed to US$95.

The Position of the Tymoshenko Administration

The long political crisis in Ukraine, with early parliamentary elections in September 2007 and the creation of a new coalition government under Yuliya Tymoshenko only in December, caused considerable debts from gas deliveries to accumulate again, while on the other hand, no agreement was reached on the delivery price for 2008. At the beginning of February 2008, Gazprom threatened to cut off deliveries to Ukraine unless remaining debts of US$1.5 billion were repaid within a short period of time.

Tymochenko, who represents a decided pro-Western course for Ukraine, had already accused Russia during the election campaign of politicizing the gas issue. She demanded that the dubious intermediaries be excluded and transit fees be raised drastically. At the same time, she demanded an overhaul of state company Naftohaz, which she accused of mismanagement.

On 12 February, Ukrainian President Viktor Yushchenko reached a last-minute agreement with his Russian counterpart Vladimir Putin in Moscow. According to initial media reports, Ukraine promised swift repayment, and both sides agreed to exclude intermediaries. At the same time, Gazprom will be permitted to deliver gas directly to Ukrainian end-users. The Ukrainian import price for 2008 was fixed at US$179.50. The details of the agreement remained unclear, however, even after Tymochenko held further negotiations in Moscow on 20 February.

In April the Ukrainian government declared that it had repaid all gas debts. However, although Tymoshenko announced the exclusion of all intermediaries beginning in spring 2008, a deal with RosUkrEnergo was made for the full year.

Conclusion

Compared to previous years, the conflict over the energy trade between Russia and Ukraine has experienced a marked relaxation despite occasional dramatic flare-ups. While 2006 still witnessed a suspension of deliveries, a drastic deterioration of foreign relations, and a trade conflict, an agreement was reached in 2008 – albeit at the last moment – that was welcomed by all parties concerned. The core issues remain unresolved, however.

As long as the import price of gas for Ukraine is not linked to the price of oil in accordance with EU practice, it will remain the object of politicized bargaining and therefore constitute a potential lever for the application of pressure in the context of Russian foreign policy. At the same time, the involvement of intermediaries causes a lack of transparency in the handling of payments and thus gives rise to suspicions of personal enrichment on the part of the Ukrainian tycoons and Russian managers involved. It is supremely ironic that Tymoshenko, who herself amassed a huge fortune in the dubious gas trade business during the 1990s, is now the one to demand strict action. Nevertheless, she does of course have a valid point. A neutral pricing formula and transparency in payment transactions are the only way to manage the gas trade in a way that is calculable and free from politicization.

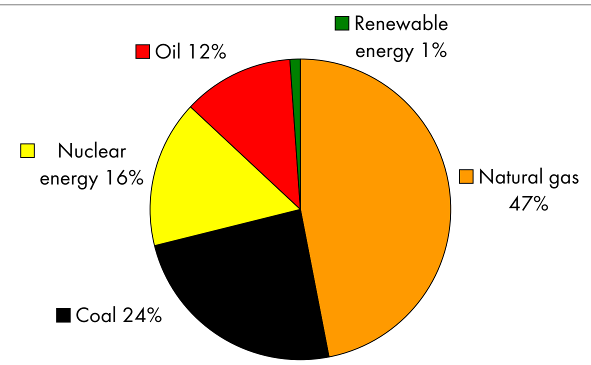
At the same time, the rapid price increase for gas places a severe strain on the Ukrainian state budget and the national economy. Production costs in heavy industry and chemical industry are increasing, and there is substantial inflationary pressure. Handling the economic consequences of rising gas prices requires comprehensive modernization efforts in the industry, a state energy-savings program, and billing for private households based on individual consumption. In these areas, the Tymoshenko administration still has a lot of work to do.

About the author
Dr. Heiko Pleines is head of the Department of Politics and Economics at the Research Centre for East European Studies at the University of Bremen.

Tables and Diagrams

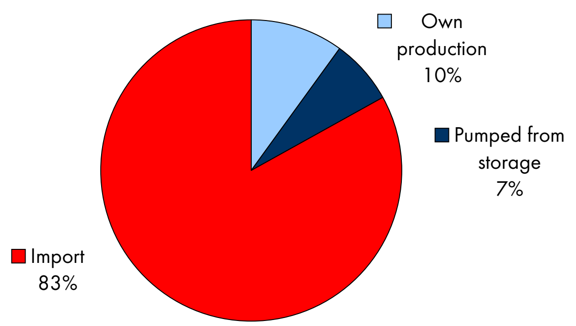
Russian–Ukrainian Natural Gas Trade

Diagram 1: Ukrainian Consumption of Primary Energy



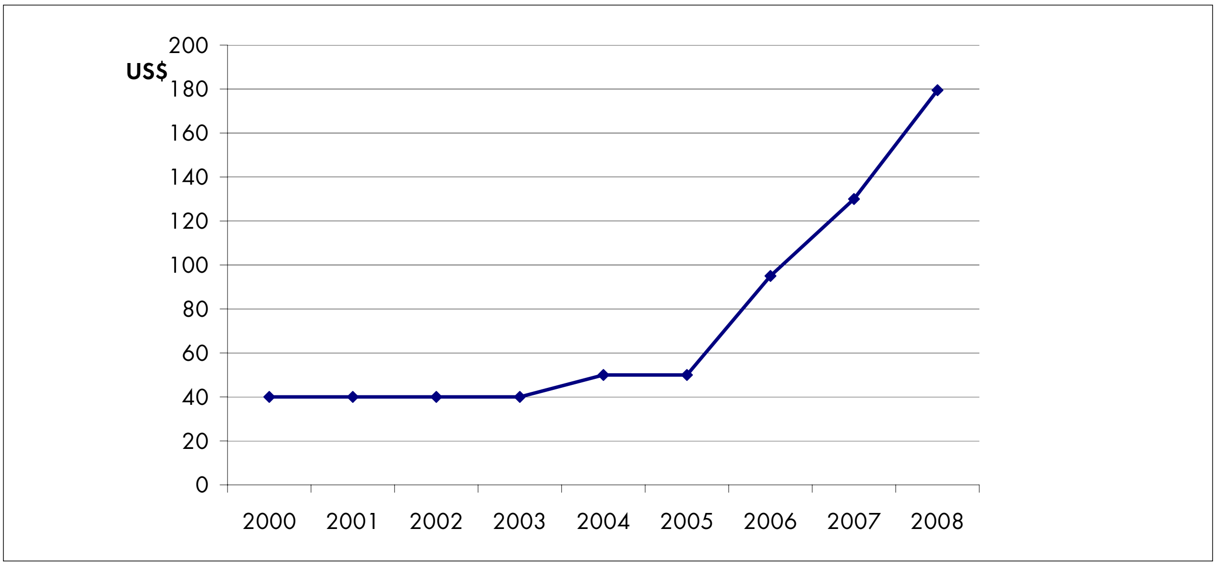
Source: Ukrainian Ministry of Energy, http://www.mpe.energy.gov.ua/

Diagram 2: Sources of Ukraine's Natural Gas Supply (2006)



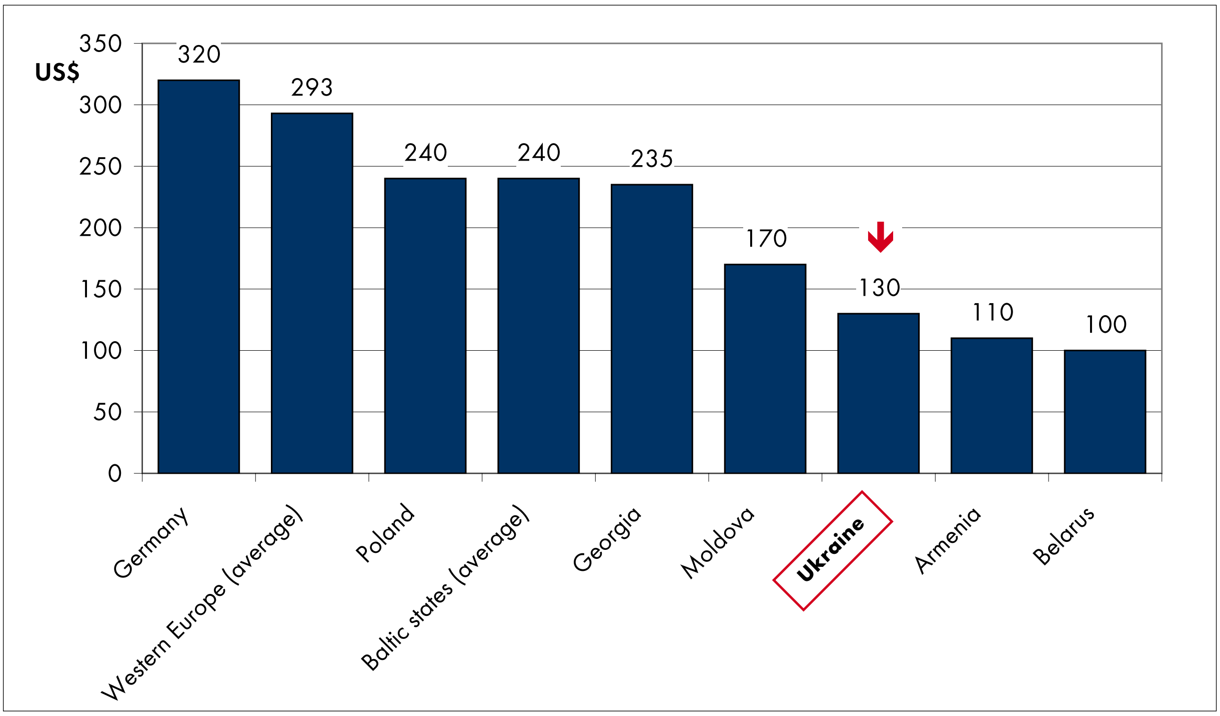
Source: Ukrainian Ministry of Energy, http://www.mpe.energy.gov.ua/

Diagram 3: Ukrainian Import Prices for Natural Gas 2000–2008



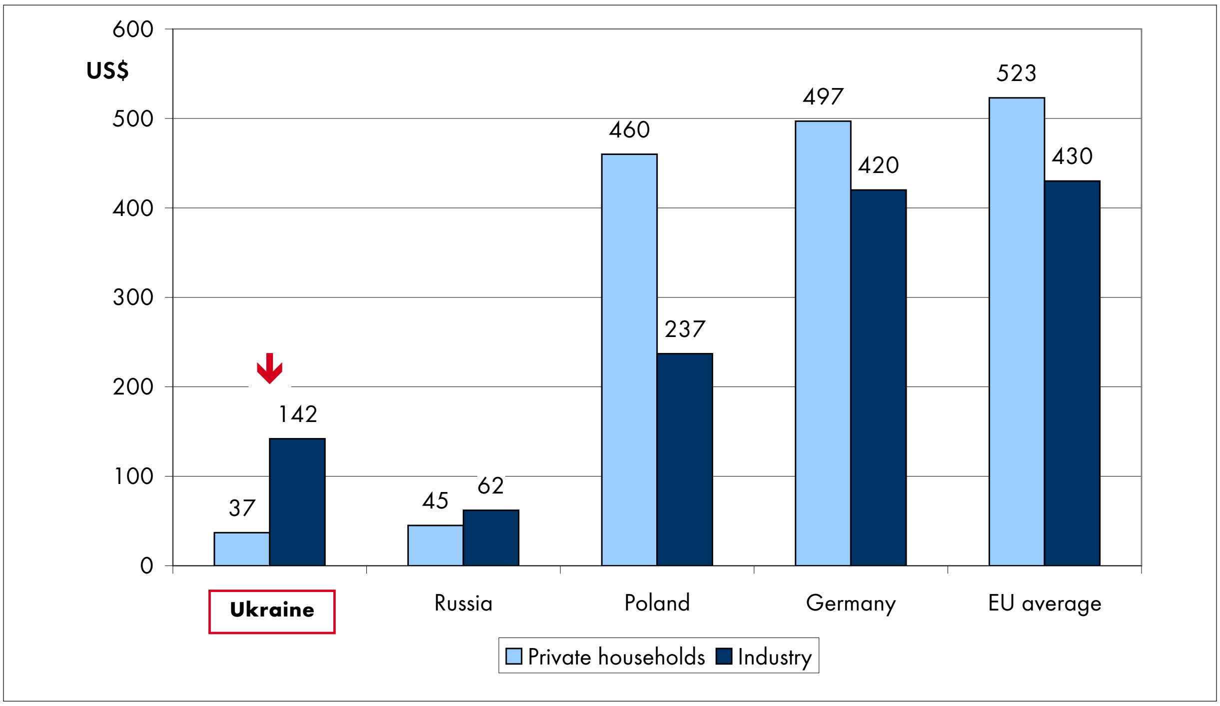
Source: Institute for Economic Research and Policy Consulting, Kiew, http://ier.org.ua/papers_en/v12_en.pdf

Diagram 4: Gazprom's Contract Prices for Natural Gas in 2007 (in US dollars per 1000 cbm)



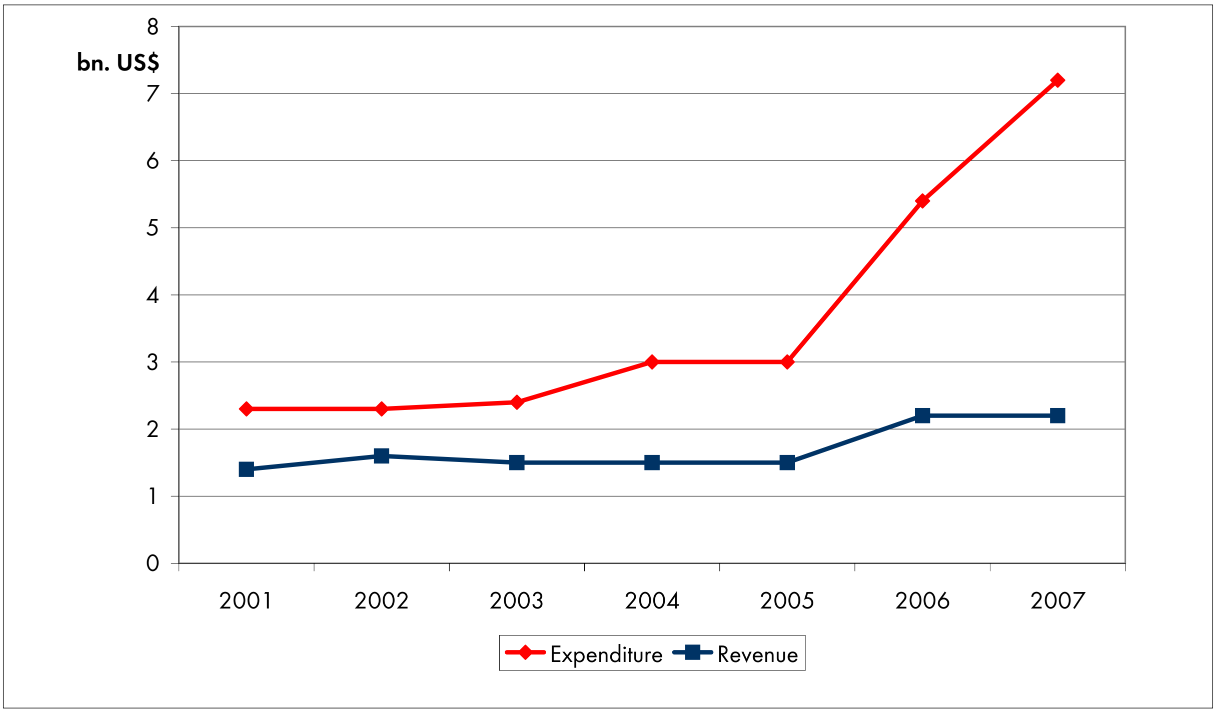
Sources: Simon Pirani: Ukraine's Gas Sector, Oxford Institute for Energy Studies, June 2007, p. 27, http://www.oxfordenergy.org/pdfs/NG21.pdf *and Bank of Finland Institute for Economies in Transition,* www.bof.fi/bofit

Diagram 5: Natural Gas Prices on the Domestic Market 2006 (in US dollars per 1000 cbm)



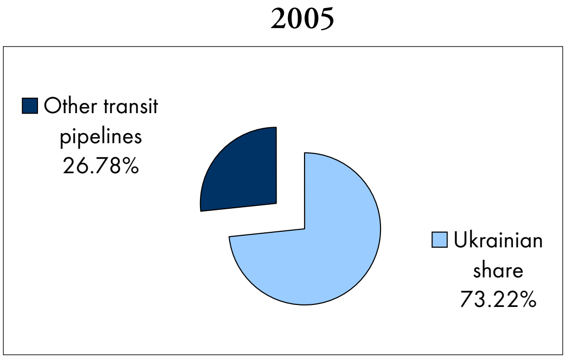
Source: Simon Pirani: Ukraine's Gas Sector, Oxford Institute for Energy Studies, June 2007, p. 26, http://www.oxfordenergy.org/pdfs/NG21.pdf

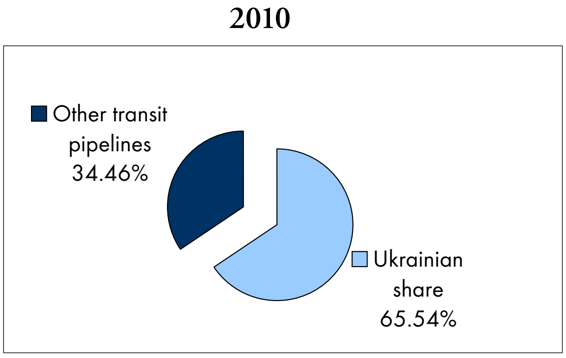
Diagram 6: Ukrainian Expenditure on Natural Gas Imports and Revenue from Natural Gas Transit (bn. US dollar)



Sources for expenditure: author's calculations based on information of the Ukrainian Ministry of Energy, http://www.mpe.energy.gov.ua/ *and Diagram 4 on p. 7 of this issue of the Russian Analytical Digest, value for 2007: author's estimate; source for transit revenue: Simon Pirani: Ukraine's Gas Sector, Oxford Institute for Energy Studies, June 2007, p. 84;* http://www.oxfordenergy.org/pdfs/NG21.pdf.

Diagram 7: Ukrainian Share of Transit Pipelines for Russian Natural Gas





Source: Research Centre for East European Studies, Bremen – author's compilation; see Table 1 below.

Table 1: Pipeline Capacities for Russian Natural Gas Exports

Pipeline	Route	Capacity 2005	Capacity 2010
Brotherhood/Union (Soviet network)	Russia – Ukraine – Central Europe	130 bn. cbm	130 bn. cbm
Polar Lights (Soviet network)	Russia – Belarus – Ukraine – Central Europe	25 bn. cbm	25 bn. cbm
Transbalkan (Soviet network)	Russia – Ukraine – Balkans	20 bn. cbm	20 bn. cbm
Finland Connector (Soviet network, extended 1999)	Russia – Finland	20 bn. cbm	20 bn. cbm
Yamal (since 1999)	Russia – Belarus – Poland – Western Europe	28 bn. cbm	28 bn. cbm
Blue Stream (since 2002)	Russia – Black Sea – Turkey	16 bn. cbm	16 bn. cbm
Baltic Sea (NEGP, probably from 2010)	Russia – Baltic Sea – Germany	–	28 bn. cbm
Total		***239 bn. cbm***	***267 bn. cbm***

Source: Research Centre for East European Studies, Bremen – author's compilation.

Suggested Reading

Working Papers of the Research Centre for East European Studies, Bremen No. 92: Russia's Energy Sector between Politics and Business

Robert Orttung, Jeronim Perovic, Heiko Pleines, Hans-Henning Schröder (eds.), 98 pages
ISSN: 1616-7384

Price: 4 Euro + p & p

Please direct your orders to: fsopr@uni-bremen.de
Forschungsstelle Osteuropa, Publikationsreferat, Klagenfurter Str. 3, D-28359 Bremen, Germany

Contents

(continued on next page)

Part III: Energy and Foreign Policy

Part IV: Ecological Challenges

About the Russian Analytical Digest

The Russian Analytical Digest is a bi-weekly internet publication jointly produced by the Research Centre for East European Studies [Forschungsstelle Osteuropa] at the University of Bremen (www.forschungsstelle-uni-bremen.de) and the Center for Security Studies (CSS) at the Swiss Federal Institute of Technology Zurich (ETH Zurich). It is supported by the Otto Wolff Foundation and the German Association for East European Studies (DGO). The Digest draws on contributions to the German-language Russlandanalysen (www.laender-analysen.de/russland), the CSS analytical network on Russia and Eurasia (www.res.ethz.ch), and the Russian Regional Report. The Russian Analytical Digest covers political, economic, and social developments in Russia and its regions, and looks at Russia's role in international relations.

To subscribe or unsubscribe to the Russian Analytical Digest, please visit our web page at www.res.ethz.ch/analysis/rad

Research Centre for East European Studies [Forschungsstelle Osteuropa] at the University of Bremen

Founded in 1982 and led by Prof. Dr. Wolfgang Eichwede, the Research Centre for East European Studies (Forschungsstelle Osteuropa) at the University of Bremen is dedicated to socialist and post-socialist cultural and societal developments in the countries of Central and Eastern Europe.

The Research Centre possesses a unique collection of alternative culture and independent writings from the former socialist countries in its archive. In addition to extensive individual research on dissidence and society in socialist societies, since January 2007 a group of international research institutes is participating in a collaborative project on the theme "The other Eastern Europe – the 1960s to the 1980s, dissidence in politics and society, alternatives in culture. Contributions to comparative contemporary history", which is funded by the Volkswagen Foundation.

In the area of post-socialist societies, extensive research projects have been conducted in recent years with emphasis on political decision-making processes, economic culture and the integration of post-socialist countries into EU governance. One of the core missions of the institute is the dissemination of academic knowledge to the interested public. This includes regular email service with nearly 15,000 subscribers in politics, economics and the media.

With a collection of publications on Eastern Europe unique in Germany, the Research Centre is also a contact point for researchers as well as the interested public. The Research Centre has approximately 300 periodicals from Russia alone, which are available in the institute's library. News reports as well as academic literature is systematically processed and analyzed in data bases.

The Center for Security Studies (CSS) at ETH Zurich

The Center for Security Studies (CSS) at the Swiss Federal Institute of Technology (ETH Zurich) is a Swiss academic center of competence that specializes in research, teaching, and information services in the fields of international and Swiss security studies. The CSS also acts as a consultant to various political bodies and the general public.

The CSS is engaged in research projects with a number of Swiss and international partners. The Center's research focus is on new risks, European and transatlantic security, strategy and doctrine, state failure and state building, and Swiss foreign and security policy.

In its teaching capacity, the CSS contributes to the ETH Zurich-based Bachelor of Arts (BA) degree course for prospective professional military officers in the Swiss army and the ETH and University of Zurich-based MA program in Comparative and International Studies (MACIS), offers and develops specialized courses and study programs to all ETH Zurich and University of Zurich students, and has the lead in the Executive Masters degree program in Security Policy and Crisis Management (MAS ETH SPCM), which is offered by ETH Zurich. The program is tailored to the needs of experienced senior executives and managers from the private and public sectors, the policy community, and the armed forces.

The CSS runs the International Relations and Security Network (ISN), and in cooperation with partner institutes manages the Comprehensive Risk Analysis and Management Network (CRN), the Parallel History Project on NATO and the Warsaw Pact (PHP), the Swiss Foreign and Security Policy Network (SSN), and the Russian and Eurasian Security (RES) Network.

Any opinions expressed in Russian Analytical Digest are exclusively those of the authors.
Reprint possible with permission by the editors.
Editors: Matthias Neumann, Robert Orttung, Jeronim Perović, Heiko Pleines, Hans-Henning Schröder
Layout: Cengiz Kibaroglu, Matthias Neumann

Research Centre for East European Studies • Publications Department • Klagenfurter Str. 3 • 28359 Bremen • Germany
Phone: +49 421-218-7891 • Telefax: +49 421-218-3269 • e-mail: fsopr@uni-bremen.de • Internet: www.res.ethz.ch/analysis/rad