

The Implications of Russia's Use of Gas as a Political Weapon

Carolina Novac

December 2014

On October 30, Ukraine and the European Union concluded a deal in Brussels that would restart supplies of Russian gas to Ukraine over the winter in return for payments funded by the International Monetary Fund (IMF), the EU, the Ukrainian state-owned energy company Naftogaz, and the Ukrainian Government.

On June 15, Gazprom took Naftogaz to the Stockholm Arbitration Court, demanding payment of a \$4.5bn outstanding debt. In turn, Naftogaz demanded the return of \$6bn by Gazprom, which Naftogaz said it paid extra between 2010 and 2014 for gas deliveries. Neither part intended to pay, so Gazprom's next step was halting gas supplies to its neighbor. What seemed to be happening was a third "gas war".

The European Commission intervened as a mediator between Kiev and Moscow. The result of the mediation was a so-called "winter package", meant to avoid a repetition of the gas crisis of January 2009 that left part of the EU and the Western Balkans in the cold. Negotiations were very hard, but as the European Commissioner for Energy Oettinger said, an agreement was absolutely necessary instead of waiting for the final decision from the Stockholm Arbitration Court.

Worth \$4.6bn in total, the package called for Ukraine to pay \$3.1bn in two tranches by the end of the year: a first tranche of \$1.45bn for the gas delivered in November and December of 2013 and a second tranche of \$1.65bn for the April-June interval of 2014. This would cover all the debts which lead to the cutoff of gas to Ukraine in 16 June.

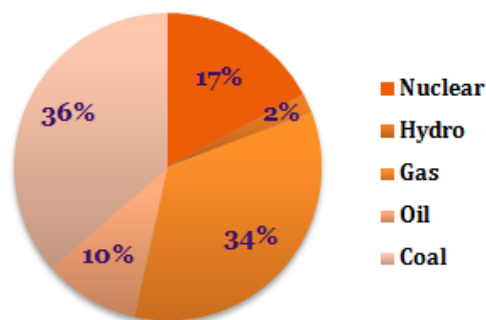
Initially, Gazprom insisted on Ukraine paying a \$5.3bn debt and importing gas at a higher price – \$485 per thousand cubic meters (kcm). The final deal, however, secures gas for Ukraine at a reduced price: \$378/kcm for November and December and \$365/kcm for the January-March interval, plus the payment of the \$3.1bn debts. The rest of the supposed debt, \$2.2 bn, will be decided by Stockholm Arbitration Court.

Naftogaz said on November 4 it had transferred \$1.45bn to Gazprom, covering the first tranche of debt repayment, which was required in order for Moscow to resume gas supplies to its neighbor.

Thanks to this agreement, Ukraine is free to order as much gas as it needs and is not subject to take-or-pay obligations foreseen in the current contract. As Ukrainian Energy Minister Yuri Prodan announced, “Ukraine has not started to import Russian gas as weather conditions are favorable, but it foresees to purchase 1.5bcm of gas at a \$378 price until the end of the year 2014”¹.

Naftogaz confirmed the information: “Russian gas is still not needed and Ukraine is not in urge of it, so basic supplies are coming from Europe”². This fits with Naftogaz’ intention to diversify supply. As stated also by Naftogaz CEO Andrey Kobolev, “Kiev does not want to depend on any one source for more than 30% of imports”³.

Figure 1.1 Primary energy mix 2013



Source: International Energy Agency

Currently Ukraine consumes mostly coal and fuel oil from its domestic production. Besides, it uses the gas it has stored (15.2bcm). It also imports gas from the EU and has adopted drastic austerity measures for gas consumption (supplies have been cut by 20% for residents and 30% for industry). The consequences of the overly rigid price policy of Gazprom against

Ukraine increased primary coal consumption (which reached 36% in 2014 from 31% in 2010), while natural gas consumption is only 34% (from 40% in 2010), as shown in figure 1.1.⁴

¹ 18.11.2014, <http://economics.unian.net/energetics/1010564-ukraina-mojet-do-1-dekabrya-predoplatit-gazpromu-15-mlrd-kubometrov-gaza.html>

² “Украина попытается обойтись без российского газа”

http://finance.rambler.ru/news/analytics/153228582.html?utm_source=&utm_medium=rexchange&utm_campaign=49

³ “Ukraine to keep buying gas from Russian, European companies – Naftogaz CEO” <http://en.itar-tass.com/economy/760426>

⁴ International Energy Agency, “Executive summary and key recommendations”, p.16, http://www.iea.org/publications/freepublications/publication/uk_summaryplus.pdf

Apart from this, the Ministry of Finance, alongside other governmental departments, has already developed eight options for substitution of Russian gas imports. The alternatives are: **biofuel**, which has to be used in settlements of no more than 20 thousand inhabitants; **syngas**, obtained by gasification of coal; **deep drilling technology**, which would increase the domestic production of oil and gas; **coal-water slurry fuel** (CWSF), which is a fuel consisting of fine coal particles suspended in water; **use of electricity at night**; an **LNG regasification terminal**; the use of **synthesis gas** (SNG) and **syngas** (SG) in the chemical industry. Syngas's main application is electricity generation; as a fuel is often used in internal combustion engines.⁵

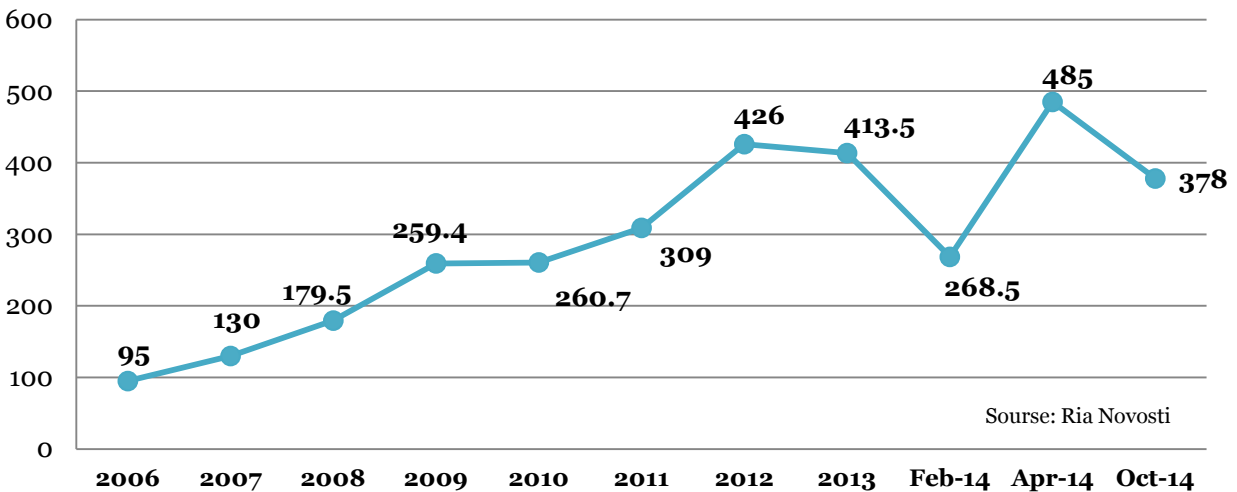
Since the beginning of the dispute, the total amount of gas that Ukraine has imported through reverse flow was 3.1 bcm, nearly 1 bcm in September and 0.89 bcm in October. The largest European energy companies came to help: Norwegian Statoil, German EON and RWE, French GDF Suez, Europe-based US trader TrailStone.

Approximately 27 mcm of gas per day is going on the reverse-flow scheme through the Slovak transport operator Eustream to Ukraine. The source is divided between four companies: the Statoil (which accounted for about half of the volumes), EON, GDF Suez and TrailStone. In September, RWE supplied 20 mcm/day to Ukraine through Slovakia, but it halted reverse flow from October 2014.

Statoil sells 12-15 mcm/day to Ukraine through a swap scheme: it trades its own gas on the German market in exchange of Russian gas, which it brings into Slovakia through Eustream. In October the gas was sold at a price of \$350/kcm (the \$320 swap price plus the transportation cost), \$35 lower than the Gazprom sold gas.

⁵ 04.07.2014, http://www.minfin.gov.ua/control/uk/publish/article?art_id=400363&cat_id=53608

Figure 1.2 **Gazprom exports prices (\$) to Ukraine**



Since April, GDF started reverse-flow selling to Ukraine via Hungary; because of the high transport costs, in September it changed the supply route through Slovakia.

Overall, in September, Ukraine received 780 mcm on the Slovak route, another 117 mcm from Poland and 90 mcm through Hungary. Previously, Slovakia stated that it is ready to deliver up to 10 bcm/year to Ukraine. On October 3, the Ukrainian Minister Yuriy Semerak mentioned that Kiev saved about \$500m on the reverse gas supplies.⁶

As shown in Gazprom's financial statement, the price of gas exports to EU countries in the first half of this year was \$366/kcm⁷, while the newly agreed price to Ukraine is \$378/kcm. Most likely in the second half of this year export price to the EU will further go down due to falling oil prices.

Despite its tense political relations with Russia, Ukraine is not trying to avoid Russian gas; it merely wants a lower price, in order to accommodate its deep economical problems.

From January to August of 2014, domestic gas consumption in Ukraine fell by 15.5% to 27.3 bcm compared to the same period of 2013. Over the same period, the country produced 13.19 bcm (+ 2.5%) and imported 15.13 bcm (-1.2%).⁸

⁶ 3.10.2014, <http://lenta.ru/news/2014/10/03/ukrrevgas/>

⁷ Gazprom, "Financial information under IFRS for the six months ended June 30, 2014", <http://www.gazprom.com/f/posts/55/477129/gazprom-ifrs-2q2014-en.pdf>

⁸ <http://top.rbc.ru/business/09/10/2014/543658cacbb20fba1b2f6c89>

Through the reverse-flow mechanism of gas supply, the Russian gas transited through Ukrainian routes returns to Ukraine as European gas. Even though in May Russian Foreign Minister Serghey Lavrov mentioned that Bratislava's decision on reverse flow was not a derogation from the contract with Gazprom, Gazprom CEO Alexei Miller later announced, in June, the possibility of sanctioning the companies applying reverse flow. On this line, on September 8-9, Gazprom decreased supplies to Poland by 20-24%; on September 10, Slovakia announced about reduced gas supplies as well (10%); on September 11, Austria registered a 15% cut in gas supplies. Romania and Germany were confronted with the same problem.

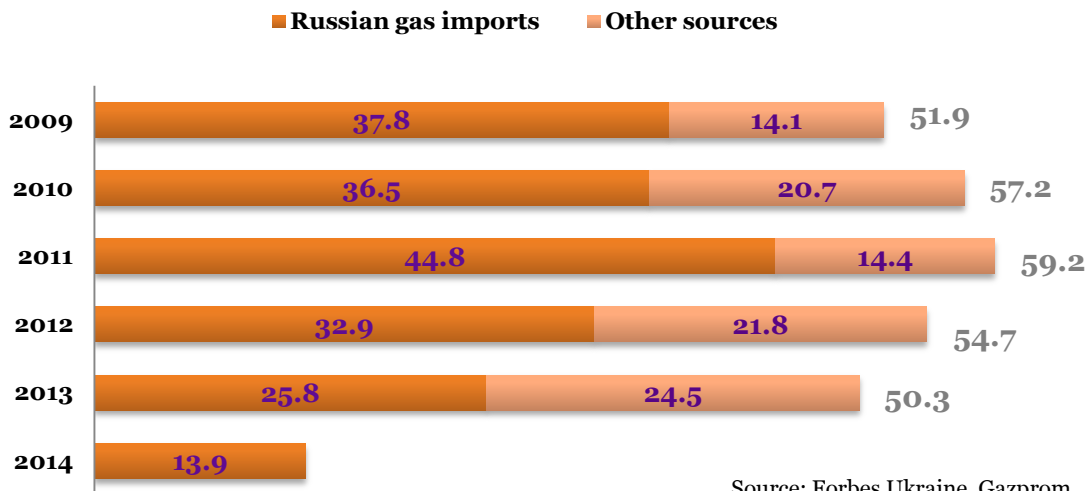
The Russian determination to sabotage the reverse gas flows from Europe to Ukraine is also demonstrated by the Russian Energy Minister's statement that "uninterrupted supply of gas to Europe can only be guaranteed if the recipients honor the contracts they have concluded with Russia, which do not provide for the re-export of the gas", as well as by reports that the Russian State Duma is working on a law prohibiting the export of energy resources to countries with energy debts to Russia, and to countries which re-export Russian gas to third countries which have financial debts to Russia.⁹

Russia made the concessions of agreeing to lowering the price from the initially requested \$485/kcm to \$378/kcm, as well as accepting the \$3.1bn debt repayment mainly because of Western sanctions, the lowest oil prices since 2008 and the devaluation of the Rouble.

Compared to September 2013, Russian gas exports to the Community of Independent States (CIS) countries fell by almost 70% in September 2014, from 5.6bcm to 1.8bcm. The largest decrease was in gas supplies to Ukraine – about 4bcm. Imports of Russian gas to Ukraine had already decreased last year to a record low of 25.8bcm as a result of an active policy led by Yanukovych and Azarov on reducing dependence on Russian gas.

⁹ Centre for Eastern Studies, "Gas negotiations Ukraine-Russia-EU: war of attrition", 08. 10.2014, <http://www.osw.waw.pl/en/publikacje/analyses/2014-10-08/gas-negotiations-ukraine-russia-eu-war-attrition>

Figure 1.3 **Ukraine's gas consumption**



Gazprom is facing a tough situation. According to international standards, from January to March 2014, Gazprom’s net profit has dropped 40% to \$6.19bn, although deliveries to European customers increased.¹⁰ Profit would diminish as gas delivery to Ukraine has stopped – not to mention that in September and October alone, because of the reverse-flow to Ukraine, Gazprom limited gas supplies to European countries, which cost it more than \$1.5bn in revenue.¹¹

Ukraine by itself does not register significantly on Gazprom’s balance sheet, according to its annual reports, but it is an important element in the economic chain of Russia.¹² The Russian gas monopoly simply could not continue to tolerate such a loss of revenue, so in spite of all political issues, Moscow had to sign the agreement.

More than 30% of Europe’s gas comes from Gazprom, half of it flowing through Ukraine. That is why Europe could ill afford other gas crises like those of 2006 and 2009. Any disruption of Russian gas to Ukraine this winter will have real effects on European consumers and raise the prospect of virtual abandonment Russia as a gas supplier to the EU.

Mary Dejevsky notes in *The Independent* that Ukraine has the potential “to hold the whole EU hostage in pursuit of a bilateral dispute with Russia.” It would be irrational, in

¹⁰ 11.09.2014, <http://ru.euronews.com/2014/09/11/hard-times-at-gazprom-poland-says-russia-gas-deliveries-fall/>

¹¹ Elena Mazneva, “Gazprom Said to Face Biggest Drop in EU Revenue in 5 Years”, <http://www.bloomberg.com/news/2014-09-10/gazprom-said-to-face-biggest-decline-in-eu-revenue-in-5-years.html>

¹² Kenneth Rapoza, “Gazprom Gets Paid, But Russian Gas Bill Still Due In Ukraine”, <http://www.forbes.com/sites/kenrapoza/2014/11/04/gazprom-gets-paid-but-overdue-bills-still-due-in-ukraine/>

the actual context, for Russia to allow a third gas crisis to take place. This could have a strong, long-term effect on the European gas market.

In conclusion, Russia has made great concessions in signing the winter package as it was pressured by the enumerated factors. Nevertheless, Ukraine is seriously determined to find alternatives to Russian gas through all available options. In the long-term, by imposing higher prices for gas to Ukrainians, Gazprom risks losing a large market.

Ukraine needs a transformation of its energy sector to a more efficient, secure and sustainable energy system. Alongside the EU, Ukraine needs to implement a reformed gas policy to avoid the high risks of a gas supply cut-off every winter. As long as it will have political and economic stability Ukraine can build the capacity to significantly increase its resource production.

Apart from its problems in the East, Kiev already took a number of initiatives and further steps for reforms in the energy sector which are supported by the EU and the IMF. It is crucial to streamline the energy sector, to have a strong security policy in energy and to further continue its determination to diversify from Russian gas.

Carolina Novac is an Energy Policy Group Junior Analyst

Copyright © 2014 **Energy Policy Group**

Str. Buzești 75-77, 011013

București, Romania

www.enpg.ro

office@enpg.ro