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The 2010 Gas Conflict: To be or not to be?

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As 2010 approaches, the EU is holding its breath and wondering what New Year's gift Ukraine and Russia will bring—stable natural gas supplies or yet another mid-winter crisis. On one hand, Russia and Ukraine do not have to negotiate on a new gas contract and Russia has stated that Ukraine will not be fined for buying less gas in 2009. On the other hand, election fever in Ukraine and difficulties with finding the cash to pay monthly gas bills are raising new concerns. In short, the stability of Russian gas supplies through Ukraine is not guaranteed. Extremely strict payment terms and the inability of Naftogaz Ukrainy, the state gas monopolist, to pay its bills on its own potentially jeopardize gas supply security every month now

Coming to terms...sort of

In the last five years, the start of every new year has become a test in Russia-Ukraine energy relations. Tough negotiations on gas contracts for each upcoming year regularly blew up into acrimonious gas disputes. The question of gas prices and opaque trading schemes often provoked conflicts.

But in 2009, Russia-Ukraine gas relations appeared to be fixed by the signing of 10-year gas supply and transit contracts. This represented a positive new development. Ukraine began to pay close-to a market price for gas,¹ all intermediaries between Gazprom and Naftogaz were eliminated, and the terms of payment became more predictable. At last, it seems there were no objective reasons for disruptions of gas supplies the following year, 2010.

Still, the gas contracts signed on 19 January 2009 did not bring an end to instability in gas supplies transiting through Ukraine. Much higher gas prices and extremely strict conditions for gas payments be-

came major risk factors for Ukraine. For one thing, the price of gas for Ukraine increased substantially, from around US \$180/1,000 cu m in 2008 to US \$228/1,000 cu m on average in 2009.² Moreover, under the terms of the contract, Ukraine was obligated to make monthly payments by the 7th of the month following delivery, or it would be fined and required to begin paying in advance.

These terms became a real burden for the Ukrainian economy at the height of a global economic crisis. First of all, for Naftogaz Ukrainy, making payments that were both monthly and much higher proved unrealistic. The company's completely unbalanced financial structure simply did not allow for regular payments to be made on its own. Thus, the state had to intervene. Payments were made using all possible means, including loans by Oschadny Bank, government bonds purchased by the National Bank

¹ According to the 19 January 2009 contract, the price of gas for Ukraine is calculated according to a specific formula that accounts for changes in other fuel prices, which is more European. For 2009, Ukraine was given a 20% discount, but from 2010 on, it will pay full market price for natural gas.

² According to the 19 January gas contract, gas prices for Ukraine are revised every quarter. According to Naftogaz, gas price for Ukraine was US \$360/1,000 cu m in Q1'09, US \$270.95/1,000 cu m in Q2, and US \$198.34/1,000 cu m in Q3. It is expected to be around US \$208/1,000 cu m in Q4. The average price is weighted against the volume of gas purchased. (<http://rus.newsru.ua/finance/01dec2009/cena.html>)

of Ukraine, and the conversion of an SDR from the International Monetary Fund. This partly prevented the outbreak of a new conflict over gas between Russia and Ukraine. Indeed, despite all these difficulties, Ukraine has been paying its gas bills on time, so far. But if the country does not find money to pay its December bill in early January, the stability of gas supplies transiting through Ukraine could come under threat. This factor significantly puts gas supply security under risk once more, leaving Ukraine and parts of Europe sitting on a powder keg with the monthly threat of being left without gas.

Until recently, there was an additional concern: the threat of fines against Ukraine for buying less gas than it had contracted in 2009. Indeed, as the country felt the blows of the global financial crisis, gas consumption shrank substantially. Ukraine ended up taking only around 33.51bn cu m of natural gas instead of the 40bn cu m contracted for 2009.³ Based on statements by Bohdan Sokolovskiy, the Presidential advisor for international energy security, the "take or pay" terms of the contract with Gazprom meant that Ukraine could be fined as much as US \$8 billion for the gas it did not take.⁴

It was clear that Ukraine could not pay that amount, given that it was struggling already to meet monthly payments of around US \$500-700mn. Fortunately, after Russia's Premier Vladimir Putin made several statements promising that Gazprom, the Russian state monopoly, would not impose any fines on Ukraine in 2010, Gazprom and Naftogaz put these promises in writing by signing an addendum to the 2009 Russia-Ukraine gas contract on 24 November 2009. At least for 2010, then, this factor should not threaten gas supplies transiting through Ukraine to Europe. However, the question remains open whether fines will be imposed on Ukraine later, in 2011, if it buys less gas than contracted in 2010.

Political games: Who gains from a new conflict?

Apart from the purely commercial aspects of this issue, political factors come into play as well. Nobody can deny that both Moscow and Kyiv have exploited gas as a political tool. The gas question has gained an even higher profile now that a new President will be elected in Ukraine in less than a month. Moreover, the "gas card" has been a constant in Ukraine's presidential campaigns. Obviously, a new gas conflict could be in the interests of candidates who wish to discredit their opponents.

Ukraine: Presidential campaign in progress

The seemingly permanent confrontations in Ukraine's domestic politics are being aggravated by the upcoming Presidential election and are now cause for concern. In the run-up to the election, both President Yushchenko and Premier Tymoshenko are trying to get as much advantage as possible from the gas issue.

As one of the two leading candidates who are currently in power, Ms. Tymoshenko wants to show how successful she has been in negotiating a gas deal with Russia. The successful Yalta meeting put a feather in her cap when Mr. Putin once again announced that Ukraine would not be fined for buying less gas. The volume of gas to be bought by Ukraine in 2010 was also reduced to 33.75bn cu m from the 52bn cu m originally contracted. It was also agreed that transit tariffs would be raised 60% in 2010.⁵

There are rumors in Ukraine that Premier Tymoshenko promised to sell part of the country's gas transit system (GTS) assets in exchange for Gazprom's concessions. Of course, these concessions raise some suspicions, especially given that Gazprom has refused similar requests to revise gas contracts from its other European partners.⁶ Without any doubt, a new gas conflict is against Ms. Tymoshenko's interests, since it will cancel out any achievements in gas relations with her Russian counterpart.

³ Naftogaz. <http://www.naftogaz.com/www/2/nakweb.nsf/0/0491A9FCEFEF39A8C2257687005A92F6?OpenDocument&year=2009&month=12&nt=%D0%9D%D0%BE%D0%B2%D0%B8%D0%BD%D0%B8&>

⁴ <http://economics.unian.net/rus/detail/26739>

⁵ <http://www.gazprom.ru/press/news/2009/november/article71733/>

⁶ http://openbiz.com.ua/economics/news/V_ES_budut_poluchat_gaz_na_prezhnih_usloviyah.html

While it is in the interests of her rivals for the Presidency to discredit Premier Tymoshenko's claim to be a successful negotiator, only President Yushchenko has the real means to do so. As a result, he has been adamant about the need to revise the January 2009 gas contract. One major argument in favor of such a revision is that the terms of the contract are quite asymmetrical.⁷ For Mr. Yushchenko, it is extremely important to bring this issue up for discussion before the election, so he will definitely continue his line. On 8 December, a new analytical report on threats to the national interests in the gas sector was published on the official site of the National Security Council of Ukraine, making it clear that the President means business.⁸ Yet the most vulnerable points were addressed in the addendum to the January contract signed on 24 November, so this factor is unlikely to lead to a new crisis.

Russia: A "friendlier" President in Ukraine

For Russia, the main political issue is to see a more "Russia-friendly" President in Ukraine. Since Mr. Yushchenko came to office in early 2005, Russia-Ukraine relations have often been quite chilly. Moscow has repeatedly accused President Yushchenko of pursuing an "anti-Russian" policy and of "spoiling" relations between "fraternal nations." Russian President Medvedev's August speech as to why Russia would not be replacing Mr. Chernomyrdin as ambassador to Kyiv was clearly—and very undiplomatically—directed against Mr. Yushchenko. "Nationalistic interpretations" of Ukrainian history, Ukraine's "support" of Georgia during the 2008 war, Ukraine's NATO ambitions, and conflicts around Russia's Black Sea Fleet displeased Ukraine's "big brother" no end.

Russia stated directly that it favors any candidate with less pro-Western and less nation-building ambitions. As it happens, all the main candidates for the Presidency favor a more reserved foreign policy and are interested in building pragmatic relations with Russia.

According to a recent Kyiv International Institute of Sociology poll, there are two clear front-runners for the presidential post in Ukraine: Viktor Yanukovich (28.1%) and Yulia Tymoshenko (16.8%).⁹ They both suit Russia. A Yanukovich win would be especially sweet as it would not only mark the end of the Orange era, but also the victory of the anti-Orange candidate. But Ms. Tymoshenko is compliant enough to gain Moscow's approval as well. The recent period of successful agreements between the two states has underscored the Kremlin's growing support for Premier Tymoshenko. Moreover, with ratings in the single digits, Viktor Yushchenko's chances of even making it to the run-off are negligible. Starting a new conflict just before the January election and discrediting all the agreements reached with Ms. Tymoshenko is not entirely in Russia's interests for now.

Risk factors: Probability and impact

Our analysis suggests three risk factors that might provoke a new gas dispute:

- Difficulty paying Ukraine's gas bills;
- The threat of fines against Ukraine for buying less gas than contracted;
- An initiative by President Yushchenko to revise gas contracts.

⁷ By "asymmetrical," the President's team means the general terms of gas purchase and transit, such as "take or pay" for gas purchase but not for transit), a way above-market gas price for Ukraine and below-market gas transit tariff for Russia, and so on.

⁸ http://www.rainbow.gov.ua/files/2009/1208alt1_2.pdf

⁹ December polls, <http://www.kiis.com.ua/>

Risk factors: Probability and impact

Risk factor	Probability	Impact
<i>Trouble meeting gas bills</i>	<p>High</p> <p>Naftogaz Ukrainy has been paying its gas bills on time so far. On 9 December, it officially confirmed its readiness to pay the December bill.¹⁰ However, this factor presents a monthly risk to the security of gas supplies transiting through Ukraine.</p>	<p>Very high</p> <p>If Naftogaz Ukrainy fails to pay its gas bill, Gazprom will automatically shut off Russian gas supplies to Ukraine and most probably those transiting through Ukraine. Premier Putin has stated this on a regular basis to Ukrainian and EU leaders.</p>
<i>Threat of fines for buying less gas than contracted</i>	<p>Very low</p> <p>This will not threaten gas supply security in 2010 due to the addendum signed between Gazprom and Naftogaz on 24 November. However, if Ukraine buys less gas than contracted in 2010, the fines issue could come up again in 2011.</p>	<p>Medium</p> <p>If Naftogaz is fined for buying less gas, it may have difficulty paying the fine. This could also lead to Gazprom shutting off Russian gas transiting through Ukraine.</p>
<i>Move to revise gas contracts</i>	<p>Low</p> <p>Revising the January gas contract is only in Mr. Yushchenko's interest. Since the current contracts are valid until 2019 and it is likely that a more Russia-friendly President will come to power in January, Russia is likely to ignore this "provocation."</p>	<p>Low</p> <p>Revising the contract itself provides no grounds for supply disruption. Supplies can be disrupted only if Ukraine does not meet its purchase commitments or its monthly payments.</p>

Assessments: ICPS

Of the three factors, the first one, "Trouble meeting gas bills" is the riskiest and truly threatens the security of Russian gas supplies transiting through Ukraine every month.

Russia-Ukraine-EU gas chain: Who will suffer the most from a new conflict?

If a new conflict should arise, it would be more harmful to Ukraine than to Russia. Russia has repeatedly warned of gas supply cuts should Ukraine fail to pay its gas bills. Russia has also already discussed an "early warning mechanism" with the EU that makes the Union much better prepared for a possible new conflict this year. Russia can always blame Ukraine as "unstable," "internally-divided" and deep in election campaign chaos. Moreover, there is no need to provide additional arguments in favor of the Streams. Denmark, Sweden and Finland have given

the green light to the Nord Stream, while Italy and France have given the nod to the South Stream.

With Ukraine, the situation is reversed. After the last dispute, EU-Ukraine energy relations received a new impetus. A number of positive steps were taken: the GTS conference in Brussels, IMF loans in exchange of reforms in the country's energy sector, and successful negotiations on accession into the Energy Community. But Ukraine is already being criticized for not fulfilling its commitments regarding energy reforms. If a new conflict should arise, it would only worsen Ukraine's position. It would cancel out all the tentative progress achieved in EU-Ukraine energy relations so far and would once again "prove" how unreliable Ukraine is as a transit country. This would further spur the EU to quickly finish negotiations to construct alternative gas supply networks.

The riskiest factor that threatens security of gas supplies transiting through Ukraine comes from the Ukrainian side, since Naftogaz Ukrainy is having

¹⁰ Naftogaz. <http://www.naftogaz.com/www/2/nakweb.nsf/0/0491A9FCEFEF39A8C2257687005A92F6?OpenDocument&year=2009&month=12&nt=%D0%9D%D0%BE%D0%B2%D0%B8%D0%BD%D0%B8&>

difficulty finding the resources to pay its bill every month. The terms of payment will most probably not be changed in the foreseeable future. Therefore, the priority for Ukraine must be to find a way to guarantee stable monthly payments. If anything goes wrong this January, gas supplies could be cut as soon as February—or in any of the following months—if Ukraine fails to pay on time.

Of course, if a new gas conflict arises, Ukraine will be seen as the weakest link in the Russia-Ukraine-

EU gas chain. Lack of reforms, populist politics and internal rivalries have seriously dented the country's reputation as a stable and reliable partner.

The upcoming Presidential election will determine the way Ukraine's politics and policies develop further. There are less than three weeks left. Ukrainians can only hope that the January election will finally usher in a period of reform, internal consistency and stability in Ukraine.

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