OXFORD INSTITUTE FOR ENERGY STUDIES

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This article was completed on January 16, 2006

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Introduction[1]

In 2004, Gazprom exported around 150 Billion cubic metres of gas to 22 European countries.[2] In a Europe of 35 countries, Russian gas accounted for nearly 40% of total imports and 28% of gas demand in that year.[3] All Russian gas exports to Europe (except deliveries to Finland and the portion of Turkish exports delivered via the Blue Stream pipeline) transit through three countries: Ukraine, Belarus and Moldova. Ukraine holds the pivotal geographical position with more than 80% of Russian gas exports to Europe delivered via that country in 2004.

During the 1990s, the Ukrainian/Russian gas relationship was characterised by:

- Ukrainian inability to pay for up to 50 Bcm/year which it imported from Russia, leading to very high levels of debt and unpaid bills which led to..
- reduction of Russian gas supplies to Ukraine for short periods of time, aimed at restoring payment discipline which in turn led to..
- unauthorised diversions of the volumes in transit to European countries.

From 1991-2000, the details of the levels of debt, the delivery reductions which took place and whether they were justified, and the diversion of gas by Ukrainian parties, became hotly contested issues.

In the summer of 2004, the Russian government, Gazprom and the Ukrainian government agreed the arrangements for delivery of Central Asian (mostly Turkmen) gas to Ukraine and settlement of past debts were agreed. Aside from the financial arrangements, the agreement included a number of other provisions designed to establish more predictability in the relationship over the next five years. A Gazprom loan to the Ukrainian gas company Naftogaz[4] allowed it to pay past gas debts, and to provide an agreed foundation for at least five years of deliveries of Turkmen gas and transit of Russian gas to Europe. This agreement foresaw deliveries of Russian gas to Ukraine of 21-25 Bcm/year for the period 2005-09, as a barter payment for transit of gas to Gazprom's European customers. For this barter agreement – under which no actual money changed hands between the parties – the notional price of Russian gas sold to Ukraine was $50/mcm and the notional tariff for transit of Russian gas across Ukraine was $1.09375/mcm/00km.[5]

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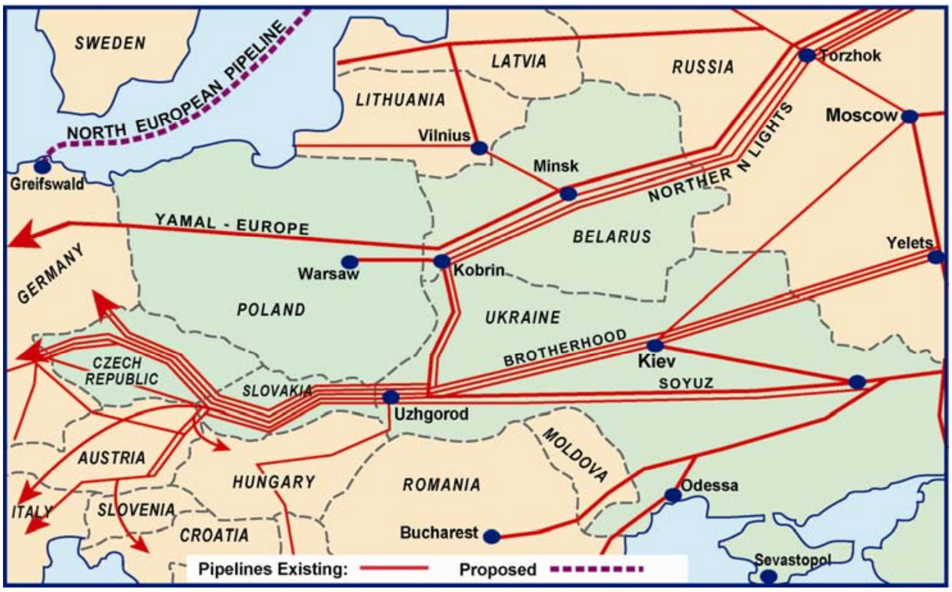
[1] A complete account of Russian gas trade with CIS and European countries, giving many more details of the events in the first two sections of this article can be found in: Jonathan P Stern, The Future of Russian Gas and Gazprom, OIES/Oxford University Press: 2005, Chapters 2 and 3 (henceforth Stern 2005).

[2] The precise figures were 140.5 Bcm of Russian gas plus nearly 8 Bcm of Central Asian gas. *Gazprom in Figures 2004*, p. 29. www.gazprom.com

[3] Calculated from, Cedigaz, *Trends and Figures in 2004*, Cedigaz/IFP: Rueil Malmaison, 2005. Europe 35 comprises all of the countries of the European Continent plus the UK, Ireland and Turkey, but excluding all former Soviet states apart from the Baltic countries.

[4] The company Naftogaz Ukraini – abbreviated to Naftogaz in this article – is also known in the Ukrainian literature as "Neftegaz".

[5] A copy of the agreement was published in *Ukrainskaya Pravda*, January 5, 2006, http://www2.pravda.com.ua/ru/news/2006/1/5/36448.htm



Source: Stern, 2005

By late 2004 therefore, it seemed that the required elements for regularising Russian-Ukrainian-Turkmen gas trade were in place for the next 5-10 years:

- Ukrainian debts to Gazprom had been agreed and settled;
- Delivery of Turkmen gas to Ukraine in terms of sales volumes and shipping arrangements had been agreed;
- Sales volumes and prices of Russian gas to Ukraine, and transit volumes and tariffs for Russian gas to Europe, had been agreed as a barter deal.
- A consortium of Gazprom and Naftogaz (potentially with German and other European participation) had been founded with the aim of operating and refurbishing the Ukrainian transit pipeline network. Gazprom had long expressed the wish to take ownership in Ukrainian transit pipeline assets. This would have allowed Gazprom control over the network and a way of minimising transit costs and risks.

2. Russian-Ukrainian gas developments in 2005

In December 2004, dramatic political events in Kiev saw the election of President Yushchenko, followed in 2005 by dramatic developments in relation to Ukrainian-Russian gas supplies.

The Turkmen supply interruption

Even as the Yushchenko Administration was challenging the outcome of the first (flawed) Ukrainian election and prevailing in the subsequent contest, a crisis had developed over Turkmen gas supplies. In early December 2004, the Turkmen authorities had requested a price increase from their Russian and Ukrainian counterparts from $42/mcm to $60/mcm for 2005.[6] On December 31, Turkmen gas flows were abruptly

[6]Turkmenistan may increase gas prices for Russia, Ukraine, *Interfax Oil and Gas Report*, December 2-8, 2004, p.35.

halted which precipitated a rapid negotiation between Ukraine and Turkmenistan allowing flows to restart to Ukraine on January 3, 2005 at a price of $58/mcm (50:50 cash/barter).[7] In January 2005, the new joint venture RosUkrEnergo was became the shipper of Turkmen gas, a role which had previously been carried out by Eural Transgas and earlier Itera.[8] Deliveries to Russia did not resume until May 2005 after negotiations between Turkmen President Niyazov and Gazprom Chairman Miller established that the price of $44/mcm would remain for 2005-06 but would be 100% cash rather than 50/50 cash/barter. From July 2005, Ukraine also opted to pay a cash price of $44/mcm bringing it into line with Gazprom arrangements.

During the first half of 2005, highly confusing statements emerged from both Ukrainian and Turkmen sources regarding future supply arrangements. In the aftermath of the December 2004 Turkmen price increases, it was announced that Turkmenneftegaz had signed a new contract with Naftogaz Ukraine for 50-60 Bcm/year for the period 2006-26, with the Ukrainian side to decide on the shipper of the gas.[9] This was followed by a joint Ukrainian-Iranian announcement of a new pipeline exporting Iranian gas to Europe, bringing 20-30 Bcm of Iranian gas to Ukraine via Armenia, Georgia and Russia.[10] Neither of these pipeline projects appeared to have any institutional or financial substance in terms of when they could be achieved. A more realistic note was sounded by Turkmen President Niyazov in October 2005 when he insisted that any long term gas arrangements with Ukraine would need to involve Russia.[11]

The End of the Consortium Concept

In June 2005 it was announced that the consortium concept for refurbishing and operating the Ukrainian transit pipeline network had collapsed. President Yushchenko's idea was that the consortium should focus on new pipeline construction projects rather than the existing network. By contrast the Russian position was that:[12]

> "The idea was to develop and manage the entire system and the Bogorodchany-Uzhgorod pipeline was interesting as a first stage. Ukraine is not ready to discuss transferring the system to the consortium. So the first stage without a second is not interesting. There is no point in deluding potential European partners about the prospects for this joint venture."

The Storage Episode

In May 2005 it was revealed that 7.8 Bcm of gas which Gazprom had deposited in Ukrainian storage reservoirs during the previous winter had not been made available to the company despite 40 requests sent between October 14, 2004 and March 22, 2005.[13] A large number of accounts were published variously suggesting that the gas was missing, or had disappeared (due to technical problems) or had been stolen by persons

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[7] RosUkrEnergo arranges the shipping of these volumes from the Turkmen border to the Ukrainian border.

[8] RosUkrEnergo is owned 50% by Gazprombank and 50% by a subsidiary of the Austrian Raffeisen Bank.

[9] *Central Asia Energy Monthly,* April 2005, p.8.

[10] Ukraine Offers to transport Iranian gas to Europe, *Gas Matters Today*, July 14, 2005; Iran plans gas exports to Europe via Ukraine, *Reuters*, July 26, 2005.

[11] Ukraine squeezed by Russia and Turkmen gas pricing ambitions, *Gas Matters*, October 2005, pp.18-21.

[12] Gas transport consortium may be liquidated, *Interfax Oil and Gas Report*, June 2-8, 2005, pp. 8-9.

[13] Gazprom insists on export price for vanished gas, *Interfax Oil and Gas Report*, June 9-15, 2005, pp. 8-9.

unknown. It subsequently transpired that sufficient gas was present in the storages to honour the commitment. However, the issue of how the gas was to be paid for and delivered, remained to be resolved. Initially, Gazprom appeared to suggest that the volumes would be subtracted from transit payments to Ukraine which would have meant – given the volumes which had already been delivered in 2005 – that Ukraine would have received virtually no additional gas during the remainder of 2005. This led to Ukrainian statements that in the event of such action, gas in transit to Europe would be taken to make up the shortfall.[14] Following that exchange, Gazprom suggested that because it was destined for export to Europe, Ukraine should pay European export prices, which would have amounted to more than $600 million. The problem was settled by an agreement between the two sides which envisaged a two-stage repayment of the volumes:[15]

- 2.55 Bcm of gas as repayment of Gazprom's transit liabilities;
- 5.25 Bcm of gas to be delivered to RosUkrEnergo during 2005-06.

In addition, the volume of gas transited through the Ukraine to European countries would increase by 8 Bcm in 2005 and by 8-11.5 Bcm in 2006. However, the episode raised serious questions as to whether Russian gas stored in the Ukraine can, in future, be regarded as secure and whether this could be problematic for European supplies.

"European" prices and transit tariffs

A dramatic early initiative from the Yushchenko Administration in March/April 2005 was the suggestion that gas transit tariffs should be moved to "European" levels and paid in dollars.[16] This proposal was enthusiastically received by Gazprom raised the possibility that the latter would consider paying European market prices for Russian gas. Furthermore, it created the impression that President Yushchenko had declared the 2004 contract to be "invalid".[17] In July 2005, the Russian Duma (in response to a request from the Prime Minister) voted unanimously that CIS countries - Georgia, Moldova, Ukraine, Estonia, Latvia and Lithuania - should pay "world" (ie European) prices for gas.[18] This was followed by a declaration in August 2005 by the Ukrainian Energy Minister, heavily qualifying its original proposal, that trade will move to a cash basis in 2006-07 "if this is in Ukrainian interests".[19]

[14]Ukrainian gas company warns Russia over low gas supplies, *BBC Monitoring Service*, July 1, 2005.

[15]*Gazprom and Naftogaz Ukrainy settle 7.8 bcm of Russian gas in Ukrainian ugs facilities problem*, Press Release, www.gazprom.ru, July 17, 2005; Russia and Ukraine remain tetchy despite storage agreement, *Gas Matters*, July 2005, pp. 15-19.

[16]*On Alexey Miller's meeting with Ivan Plachkov and Alexey Ivchenko*, Gazprom Press Release, March 28, 2005.

[17] This is claimed in *Expert: Ukraine vs Gazprom: the price of the problem,* www.regnum.ru/english/569483.html This could be the reason why, despite subsequent assertions by both Russian and Ukrainian commentators that the August 2004 contract remains in force, no legal action has been taken by the Ukrainian side. Had the Ukrainian President himself not started the revision of that contract, the Ukrainian side would surely have claimed that there was no basis to renegotiate the agreement until 2009.

[18] Duma proposes gas price change for neighbouring countries, *Interfax Oil and Gas Report*, July 7-13, 2005, p. 9.

[19] Ukraine, Russia mull cash payment for Ukrainian gas transit, *Interfax Oil and Gas Report*, August 4-10, 2005, pp. 28-9.

At the same time, the new Administration in Kiev raised objections to two of the crucial elements of the August 2004 settlement: the debt settlement for previous gas supplies and the establishment of RosUkrEnergo. On the debt settlement, the view was expressed that the amount of the payment (or loan) may have been excessive. In July 2005, the Ukrainian authorities began a criminal investigation into Ukrainian interests in both RosUkrEnergo and its predecessor Eural Transgas. The Ukrainian authorities alleged that the participation of a subsidiary of the Austrian Raffeisen Bank, as 50% shareholder in RosUkrEnergo, was concealing criminal activities of Ukrainian individuals; the company has refuted these allegations.[20]

By July 2005, virtually all elements of the Russian-Ukrainian gas relationship – most of which had seemed to be settled a year earlier – had been reopened with little sign of resolution:

- it was not clear whether Ukraine would be buying Turkmen gas supplies directly or from Gazprom;
- the legitimacy of the RosUkrEnergo joint venture set up to ship Turkmen (and other Central Asian) gas to Ukraine had been called into question with the possibility that the company might face criminal charges;
- the international consortium which had been intended to address the problems of refurbishing and managing the Ukrainian gas transit network had been abandoned with nothing to replace it;
- The security of Russian gas stored in Ukraine (principally) to provide insurance for supplies to Europe during the winter months had been called into question;
- The price which Russia intended to charge Ukraine for gas which could destabilise the trade with negative consequences for European importers of Russian gas.

This disastrous deterioration in Russian-Ukrainian relations coincided with a period when oil – and therefore gas – prices were rising to new heights. By late 2005, the $50-80/mcm which the countries of the former Soviet Union were paying for Russian gas contrasted sharply with European border prices of 3-4 times that level.[21] During the final three months of 2005, negotiations between Gazprom and Naftogaz Ukraine failed to make progress:

- Gazprom demanding that from the beginning of 2006, Ukraine must pay "European prices" of between $160-230/mcm unless it was prepared to consider allowing Gazprom an equity stake in the transit pipeline network (consistent with the Consortium idea described above). [22]

[20] See the interview with the president of Naftogaz Ukrainy, Ivchenko sees more independent future for Naftogaz Ukrainy, in *Gas Matters*, July 2005, pp. 20-23; Ukraine squeezed by Russian and Turkmen gas pricing ambitions, *Gas Matters*, October 2005, pp. 18-21. For more details on RosUkrEnergo's ownership see: Tom Warner, Pact will help secretive group tighten grip over Ukraine, *Financial Times*, January 5, 2006.
[21] Although of course many of the CIS prices was the product of transit barter deals and cannot be compared with their European counterparts.
[22] Deputy Chairman Alexander Medvedev said in an interview on December 14, 2005: "It is now clear that the time when Ukraine could have considered $160/mcm to be a market price has now passed…the generally accepted pricing formula [ie $230/mcm] will apply to Ukraine from 2006", Interview on NTV, *Interfax Oil and Gas Report,* December 8-14, p.9.

- Ukraine responding that it was prepared to pay market prices for gas but that these must be phased in over a period of time and that the maximum it was prepared to pay in 2006 was $80/mcm.

Suggestions were voiced that if Gazprom enforced these prices Ukraine would either take gas in transit to Europe, and/or raise the tariff for Russian gas in transit to Europe.[23] These produced responses that:

- Gazprom could elect to change the location of its gas sales to Europe to the Russian border, making any unsanctioned removal of gas by Ukraine a European problem[24]
- Any increase in transit tariffs by Ukraine would be matched by an increase in Russian tariffs for Turkmen gas delivered to Ukraine.[25]

There was little change in positions as the end of the year approached but prices were also risring in Central Asia where Uzbekistan announced a 25% price increase to $55/mcm (from $44/mcm) in 2006.[26] However, almost unnoticed, a major event in relation to Central Asian gas took place in the final few days of the year when a Gazprom press release revealed that the company had contracted for 30 Bcm of Turkmen gas in 2006 at a price of $65/mcm, with half of that volume to be delivered in the first quarter of the year.[27] Given the capacity of the Central Asian gas network, this meant that Gazprom had purchased all available gas from Turkmenistan for the first quarter of 2006, leaving nothing for Ukraine. It also meant that what was believed to be an existing contract between Ukraine and Turkmenistan covering the period 2002-06 could not be honoured.

Gazprom's strong position on the $230/mcm price was backed at the highest political levels in the Kremlin. Gazprom had already suggested that, if Ukraine could not afford to pay higher prices, the company would extend loans to Ukraine for this purpose. President Putin – in what proved to be a final offer which could have been considered a political concession to his Ukrainian counterpart (see below) – suggested that if the Ukrainian side was prepared to agree to this gas price, the increase could be suspended for three months before the switch to market prices.[28] The Ukrainian side rejected both suggestions and at 10.00am Moscow time on January 1, 2006, Gazprom cut off gas supplies to Ukraine.[29]

[23] There were also suggestions that Ukraine was planning to increase the port charges to Russia for the Black Sea Fleet.

[24] This point was made by Valery Yazev, Chairman of the State Duma Committee on Energy, Transport and Communications, although it was subsequently rejected by Gazprom officials. *Interfax Oil and Gas Report,* December 8-14, p.8.

[25] Interview with Deputy Chairman Alexander Medvedev on Rossiya Television, *Interfax Oil and Gas Report,* December 15-21, p.6.

[26] Uztransgaz says export gas price raised amid world market trends, Turkmenistan raises natural gas price to $60 per 1000 CU. M, *Interfax Oil and Gas Report,* October 27-November 2, 2005, p. 48 and November 17-23, 2005, p.46.

[27] *Gazprom and Turkmenistan update Turkmen gas supply conditions for 2006,* Gazprom Press Release, December 29, 2006.

[28] Russia offers delay on gas hike, *BBC News*, http://news.bbc.co.uk/go/pr/fr/-/1/hi/world.europe/4571726.stm

[29] This was carried out publicly to confirm that these were not empty threats, with Russian television carrying pictures of technicians in the Gazprom control room shutting down certain pipelines.

3. The January 2006 crisis

The impact of Gazprom action on European countries was immediate.[30] With Gazprom insisting that it was supplying the correct contractual volumes to its European customers, and Ukraine insisting that it was not taking gas from the transit pipelines to Europe to which it was not entitled, it was initially difficult to understand what was happening. But falling pressures and non-delivery of gas reported by European companies on January 1 can only have resulted from Ukrainian companies diverting gas from the pipelines or because Gazprom failed to pump enough gas into those pipelines. Given Gazprom's concern about supply security and desire to earn money from gas exports to Europe, the only explanation is that gas was taken by Ukrainian customers. There are two possible explanations why Ukraine might have believed that such action was contractually legitimate:

- first, there were statements by Naftogaz that the company had taken only Turkmen gas to which it believed itself entitled, rather than Russian gas in transit to Europe.
- second, many Ukrainian spokespersons suggested that Ukraine was "entitled" to take 15% of the gas crossing its territory in transit to Europe; or that is was entitled to take gas if the temperature dropped below -3C.[31]

Neither of these explanations can be given much credence. If there was uncertainty about whether Turkmen gas was being delivered to Ukraine, then a phone call to Turkmenistan should have been able to ascertain whether their contract was being honoured. On December 23, Interfax reported that agreement had been reached between the Turkmen and Ukrainian authorities on deliveries for 2006, but since no volumes and/or prices were mentioned, and no Russian party was not involved then it seemed likely that no contractual document had been signed, allowing Gazprom to sign its agreement with Turkmenistan on December 29.[32] Gazprom confirmed at an early stage of the crisis that no Turkmen gas supplies were available to Ukraine.[33]

In addition, there had never been any suggestion that Ukrainian gas entitlements were automatically related either to transit volumes or ambient temperatures. While the volume of gas received by Ukraine from Gazprom had traditionally been around 15% of transit volumes, these commercial terms have always been set out in annual contracts. Without a contract, Ukraine was not guaranteed a percentage of transit volumes.

The fall in volumes delivered to European Union countries caused an outcry all over Europe. By January 2, Hungary was reported to have lost up to 40% of its Russian supplies; Austrian, Slovakian and Romania supplies were said to be down by one third, France 25-30% and Poland by 14%.[34] Italy reported having lost 32 million

[30] Gazprom reported that Ukraine took 104.8 million cubic metres (mmcm) from European supplies on January 1-2, and 118.7 mmcm on January 2-3. RIA Novosti, January 3, 2006.
[31] Ukraine says it has rights to 15% of transiting gas, *Interfax Oil and Gas Report*, December 22-28, 2005, p.7.
[32] Ukraine, Turkmenistan agree on gas supply terms for 2006, *Interfax Oil and Gas Report*, December 22-28, 2005, p.32.
[33] Jeremy Page, On the spot: is Ukraine stealing gas? *Times Online*,.January 3, 2006, http://www.timesonline.co.uk/article/0,,13509-1968795,00.html
[34] Russia vows to end gas shortage, January 2, 2006, *BBC News Website*.

cubic metres, around 25% of deliveries, during January 1-3.[35] German deliveries were also affected but no further details are known. On January 2, Gazprom reacted by saying that it would pump an additional 95 million cubic metres per day into the network to compensate for Ukrainian withdrawals.[36] By January 3, Austrian and Hungarian supplies were back to normal levels although some other countries were still experiencing shortfalls.

As far as could be ascertained, by January 4 Russian gas deliveries to Europe were back to normal levels. No EU country needed to interrupt supplies to customers as a result of the reduction of Russian supplies, although the position was certainly made easier due to relatively mild weather in Europe for the time of year and the fact that many commercial and industrial customers were not operating over the New Year holiday period.[37] The dispute had lasted 4 days, three of which had resulted in shortfalls to European supplies.

Commercial resolution to the dispute

On January 4, 2006 Gazprom and Naftogaz announced an end to the dispute with the signing of a 5 year contract with the following terms:[38]

1. Gazprom will pay Naftogaz a tariff of $1.60/mcm/100km for transit of gas to Europe.
2. RosUkrEnergo will be the company which delivers gas to Ukraine. Gazprom will not deliver Russian gas to Ukraine, and Naftogaz will not export any gas which it has received from Russia.
3. RosUkrEnergo and Naftogaz will form a joint venture by February 1, 2006 in order to market gas in Ukraine which has been received via the territory of the Russian Federation,
4. RosUkrEnergo's annual gas balance will consist of:
   - 41 Bcm of Turkmen gas purchased from Gazexport and RosUkrEnergo;
   - Up to 7 Bcm of Uzbek gas purchased from Gazexport with the specific aim of swaps with deliveries to Caucasus countries;
   - up to 8 Bcm of Kazakh gas purchased from Gazexport with the specific aim of swaps with deliveries to Caucasus countries;
   - up to 17 Bcm of Russian gas purchased from Gazprom with a base price of $230/mcm

   In terms of sales:
   - 34 Bcm of gas will be sold by the joint venture (between RosUkrEnergo and Naftogaz) at $95/mcm during the first half of 2006 for the Ukrainian market without the right to re-export[39];

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http://news.bbc.co.uk/1/hi/world/europe/4575726.stm

[35] Italy lost 32 mln cu m of gas in Russia-Ukraine gas dispute, *RIA Novosti*, January 3, 2006.

[36] Russia vows to end gas shortage, January 2, 2006, *BBC News Website*. http://news.bbc.co.uk/1/hi/world/europe/4575726.stm

[37] However, interruptible customers in Hungary were instructed to switch to oil. Deliveries to Serbia were reported at very low levels due to a mix of contract expiry and non-payment to both Gazprom and Mol (the Hungarian gas company). There is speculation that the timing of the event was designed by the Russian parties on minimise the impact on EU countries.

[38] The full text of the document was published in: Tekst soglashenie mezhdu Naftogazom i Gazpromom, *Ukrainskaya Pravda, January 5, 2006.* (Rough translation by the author.) http://www2.pravda.com.ua/ru/news/2006/1/5/36448.htm

[39]It is not clear – at least to this author – whether the 34 Bcm figure refers to the full year 2006, or only the first half of the year.

- in 2007, 58 Bcm of gas will be sold by the joint venture (between RosUkrEnergo and Naftogaz) to the Ukrainian market without the right to re-export;
- 15 Bcm of gas may be exported in a joint programme with Gazexport.

5. Transit payments and gas prices may only be changed by the agreement of all parties

The agreement was signed by the three parties: Gazprom (A.B. Miller), Naftogaz (A.G. Ivchenko), RosUkrEnergo (O.A. Palchikov, K.A. Chuichenko)

The text of the agreement shows clearly that many issues had not been resolved, particularly the gas price beyond June 2006; this uncertainty was probably a product of the urgency to reach agreement resolve the ongoing crisis. It makes clear that in 2006, 41 Bcm of Turkmen gas will be available to the Ukrainian market via the Naftogaz/RosUkrEnergo joint venture; a further 15 Bcm of gas (7 Bcm from Uzbekistan and 8 from Kazakhstan) may be available. The price at which this gas will be available is not included in the agreement – only the price at which the joint venture will sell to the Ukrainian market, but Gazprom's purchase price at the Turkmen border of $65/mcm (see above), plus transit fees plus a profit margin for the joint venture is likely to amount to close to $95/mcm at the Ukrainian border.

An overall view of the Ukrainian gas balance for 2006 suggests that of the 76.5 Bcm that the country needs, 20 Bcm would be produced domestically. This would suggest an import requirement of 56.5 Bcm for 2006. The agreement demonstrates that RosUkrEnergo potentially has up to 56 Bcm of Central Asian gas and 17 Bcm of Russian gas at its disposal. Although the initial press commentary suggested that Ukraine would be taking a mixture of Central Asian and Russian gas, two days after this settlement was announced, unofficial Ukrainian sources were confirming what always seemed likely, that the country would import no Russian gas in 2006; all of its 56 Bcm of imports would be sourced from Central Asia.[40] The two major questions, which will need to be resolved before July 2006, are:

- whether a further 22 Bcm of Central Asian gas (beyond the 34 Bcm in the agreement) will be available to Ukraine;
- at what price this additional 22 Bcm could be made available.

Not promising for Ukraine in this connection was a newspaper article suggesting that when President Niyazov meets President Putin in late January, he intends to raise the price of Turkmen gas from $65/mcm to $85/mcm, which would bring the price of Turkmen gas at the Ukrainian border to around $110/mcm.[41]

A Politically Motivated Dispute?

The bulk of the commentary in the European press endorsed Ukrainian President Yushchenko's position that this was a politically motivated dispute in which the

[40] Neftegaz chastichno rassekretil khitroumnuyu skhemu postavok gaza, http://urkoil.com.ca, January 6, 2005.
[41] Irina Reznik and Alexander Bekker, Voina ne ukoncheno, *Vedmosti*, January 13, 2006.

Russian side was attempting to blackmail Ukraine politically by placing it under extreme economic pressure:[42]

> "Vladimir Putin intends to destablilise Russia's western neighbour in the hope of unseating its leader…with elections looming in Ukraine, President Putin regards this as the right time to exert pressure".

The US Secretary of State said that the episode:[43]

> "..appeared to us to be politically motivated efforts to constrain energy supply to Ukraine. The game just can't be played that way…when you do it the way it was done, with an obviously political motive, of course it causes problems."

The suggestion that the motive behind Russian actions was political, was also supported by reference to the focus on countries which had either left the Soviet Union (the Baltic countries) or those which had elected pro-European (rather than pro-Russian) governments.[44] Gazprom has implemented price increases for all the CIS countries in 2006:

- Armenia, Georgia and Azerbaijan are required to pay $110/mcm;
- Moldova was required to pay $160/mcm but has refused to do so. In some accounts the Gazprom-Moldova contract has been replaced by an arrangement under which the Naftogaz/RosUkrEnergo joint venture will take over gas to the Gazprom.[45] No gas was delivered to Moldova by Gazprom during the first 12 days of 2006.[46]

Only Belarus will continue to pay the same price of $46.7/mcm in 2006 justified by Gazprom on the grounds not only of a prospective economic union between the countries but also that – in sharp contrast to Ukraine – Gazprom already owns the Belarusian section of the Yamal export pipeline to Europe, and there are ongoing negotiations about the formation of a Beltransgaz joint venture to own and operate the domestic pipeline network.[47] None of this commentary recalled that, in February 2004, Gazprom cut off supplies to Belarus (for less than a day) in support of a price increase when the contract between the countries had expired.[48]

The prices quoted above for the different countries are not comparable because of differences in transportation costs, barter arrangements for transit, and the

[42] A whiff of a dangerous and unstable new world, leader in *The Independent*, January 3, 2006. For a sample of Europe-wide press commentary see: Press shivers from gas woes, http://news.bbc.co.uk/1/hi/world/europe/4578000.stm, January 3, 2006.

[43] *Remarks at the State Department Correspondents Association's inaugural newsmaker breakfast,* Washington DC, January 5, 2006, http://www.state.gov/secretary/rm/2006/58725.htm

[44] Neil Buckley, Moscow seeks to wield petro-power as political tool, *Financial Times*, December 23, 2005.

[45] Joint venture to supply gas to Moldova, *Interfax Oil and Gas Report,* December 29, 2005-January 11, 2006, p.12.

[46] Neil Buckley and Saray Leitner, Moldova and Russia fail to end dispute over gas price, *Financial Times*, January 13, 2006. The cessation of Gazprom supplies may be connected with the $780m gas debt which the country owed to Gazprom in December 2005, *Results Of The Working Meeting Between Alexey Miller And Zinaida Grechanii*, December 14, 2005. Press Release, www.gazprom.com.

[47] Yushchenko says Gazprom taking "irresponsible approach" to pricing, *Interfax Oil and Gas Report,* December 15-21, 2005, pp. 5-6.

[48] For a wider perspective on the Russian-Belarusian gas relationship see: Chloe Bruce, *Fraternal friction or fraternal fiction, the gas factor in Russian-Belarusian relations*, OIES 2005, http://www.oxfordenergy.org/pdfs/NG8.pdf

involvement of Gazprom in the domestic gas industries of all of these countries either as a shareholder in utility companies and/or an owner of transmission assets. Nevertheless, the $230/mcm price of Russian gas to Ukraine (which as noted above is not likely to be relevant) is substantially higher than for other CIS countries and seems to have been a product of the final weeks of the negotiations when Gazprom suddenly raised the price from $160/mcm (applied to Moldova) to $230/mcm (see note 22). Indeed the $230/mcm price demand seemed designed to sever the gas supply relationship between the Gazprom and Ukraine. Even if Ukraine does elect to buy gas at this price, it will not buy any gas directly from Gazprom. Gazprom will have no direct involvement in the Ukrainian gas industry, it will simply pay a tariff in cash for transit of its gas to Europe.

Many commentators from Europe and North America widened the scope of this analysis questioning, in the light of this episode, whether:

- it was appropriate for President Putin to be chairing the G8 group of countries in 2006[49];
- Russian gas could henceforth be considered a secure source of gas supply for Europe[50];
- fundamental changes should be made to European energy policy in the direction of reducing dependence on Russian energy in general, and gas in particular, and that the EU should attend to such matters without delay.

International organisations such as the International Energy Agency, warned that the dispute risked doing fundamental and lasting damage to Russia's reputation as a reliable supplier of energy to Europe. There was very little support for the Russian position and no publicity given to the statement by the General Secretary of the World Trade Organisation that both Russia and Ukraine should pay market prices for their energy supplies, which had been a major factor in EU negotiations on Russian accession to the WTO.[51]

For all the accusations and discussion of political pressure and blackmail by Russia, it is worth noting that:

- no political demands were made either by Gazprom or the Russian government;
- it is not clear what kind of political demands the Russian side could credibly have made even had it wished to do so, as long as President Yushchenko was unwilling to back down.
- on January 10, the Ukrainian government was dismissed by a no-confidence vote in parliament following accusations by the opposition that the gas agreement signed by the government was bad for the country.[52] In the days

[49] For example Neil Buckley, Gas Pressure: why Putin is squandering world prestige in his squabble with Kiev, *Financial Times*, January 4, 2006

[50] The Kremlin tightens the energy screw, leader in the *Financial Times*, January 3, 2006.

[51] Russia and Ukraine should pay market prices – WTO Official, *RIA Novosti*, January 2, 2006. A similar point is made in: Paul Robinson, Putin plays the market, *The Spectator*, January 7, 2006. For one of the few commentaries in support of the Russian position see: Mary Dejevsky, Russia has good reason for what it is doing. Why do we have to keep demonising it? *The Independent*, January 3, 2006.

[52] The accusation by the opposition was that the government had agreed to fix transit tariffs for Russian gas for 5 years, while the purchase price of gas was only fixed for 6 months. This suggest an

which followed, President Yushchenko began to come under significant political pressure from political opponents but it is difficult to know how far this relates to the gas crisis given that the Administration was already in difficulties. It is also uncertain how the pro-Russian vote in the March 2006 elections will be impacted as a result of this episode.[53]

The crisis can be considered political in the sense that all commercial gas relationships between CIS countries require the approval – and very often the signing of the key documents – by presidents and prime ministers. It was also political in that, had President Yushchenko not won the 2004-05 elections, then relations between the two countries would not have deteriorated to the same extent, and a price accommodation between Gazprom and Naftogaz would probably have been reached. However, President Putin's proposal of a three month delay in the application of the new price regime which would have protected President Yushchenko from any effects of the price increase until after the March 2006 elections and after the worst of the winter period, could be regarded as a conciliatory political gesture.

A logical political interpretation to be placed on these events is that if Ukraine wishes to turn away politically from Russia towards the EU and NATO – and is opposed to any relationship with Gazprom in terms of ownership of gas assets - then it can expect the same commercial terms as those countries. This is akin to the political and commercial changes which took place between Russia and the former CMEA countries in Central/Eastern Europe after 1990. Had Ukraine chosen to maintain a closer political relationship with Russia, there is no doubt that it could have continued to pay lower gas prices at least for a period of time.

Nevertheless, the price changes which Gazprom has instigated with a range of other former Soviet countries – Moldova, Georgia, Azerbaijan and Armenia – represent a paradigm shift in Russia-CIS energy relations: a determined step-by-step movement towards market-based prices. Only Belarus retains gas prices at the same level as Russians domestic customers; but this is now unique among former Soviet states and continuation of these price levels may be dependent on whether Gazprom obtains a 50% share in a newly created Beltransgaz joint venture.

4. Lessons and lasting consequences of the crisis

What security lessons should Europe take away from the Russian-Ukrainian gas crisis of January 2006? The answers seem to be nothing very much more than has already been discussed in the energy security literature:[54]

- It is not wise for any country or region to become overly dependent on a single supplier or a single supply route. But defining over-dependence is not straightforward;

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inability (or a refusal) to recognise that gas prices are market-related, while transit tariffs are (or should be) cost-related. Tom Warner, Ukraine cabinet sacked over gas deal, *Financial Times*, January 11, 2006.

[53] President Yushchenko has questioned whether this action by the parliament was constitutional. In mid-January the pro-Russia parties seemed well-placed in the polls, Tom Warner, Ukraine's leader seeks to reassert his power, *Financial Times*, January 12, 2006.

[54] Most recently in, International Energy Agency, *Security of Supply in Open Gas Markets*, Paris:OECD, 2004.

- Even disputes which do not directly involve third countries can affect those countries in the event of bilateral problems between a supplier and a customer which is also a transit country;
- All parties need to be part of an international dispute resolution procedures such as that provided by the Energy Charter Treaty and its draft Transit Protocol which Russia has yet to ratify (although it has been implementing the ECT on a provisional basis).[55]

Gazprom's response to transit uncertainty has been to by-pass transit countries by building export pipelines offshore – the Blue Stream pipeline to Turkey, and the future North European Pipeline across the Baltic Sea are examples of this policy. But the geography of Russia's existing pipeline export infrastructure through Ukraine, Belarus and Moldova to Europe cannot be changed, and abandoning large parts of this infrastructure on grounds of transit insecurity is neither realistic nor cost-effective. Even when the first North European pipeline is in operation in 2010, Ukraine will control around 70% of Russia's gas export capacity to EU countries.

Any repetition of the events of January 1-4, 2006 would clearly further damage Russian credibility as a secure supplier of gas to Europe but Gazprom's action to make up the deficit – demonstrated on January 3 after two days of supply problems – was an important indicator of the company's ability to ensure supply continuity. The question remains as to what happens if Ukraine cannot secure sufficient gas from Central Asia at $95/mcm and cannot afford to pay $230/mcm for additional gas from Gazprom.

A Role for the European Union

In December 2005, it seemed as if the European Union might assume a significant role in the crisis when gas was placed on the agenda of the Ukrainian–EU Summit.[56] But the New Year holiday period placed the European Union in the difficult position of being out of action during the crucial days. A hastily convened meeting of the Gas Coordination Group on January 4 was only in time for Energy Commissioner Piebalgs to congratulate the two sides on settling the dispute stating that:[57]

> "with this action, both Gazprom and Naftogaz have proved their determination to remain wholly reliable supplies of gas and transit respectively to the EU."

However, the Commissioner also noted that the episode would cause the Commission to look again at dependence on Russian energy and gas supplies and to reappraise energy security issues.

In the aftermath of this crisis, there are some practical measures which should be considered to promote transparency and provide some comfort to EU countries in the event of another similar incident. The European Union should anticipate future problems in transit relationships between Russia and its CIS neighbours by requesting

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[55] For an overview of the Energy Charter Treaty issues, see Stern 2005, pp.135-9.

[56] EU to help resolve gas problem between Ukraine and Russia, *Interfax Oil and Gas Report*, December 1-7, 2005, pp. 6-7.

[57] Andris Piebalgs, *Speaking Notes Welcoming the agreement between Gazprom and Naftogaz*, EU Press Release, Speech 06/01, http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/06/1&format=HTML&aged=0&language=EN&guiLanguage=en

greater transparency of contracts and gas flows. These tasks could be placed on the agenda of the EU-Russia Energy Dialogue and future EU dialogue with Ukraine.[58]

A Role for the Energy Charter

The specific issues which need to be addressed are:

- Greater transparency of supply and transit contracts between Russia, Central Asian countries and CIS transit countries. During the 2006 crisis it would have been very useful for the EU to have known the contractual obligations which existed for supply and transit of gas between:
  - Turkmenistan and Russia
  - Turkmenistan and Ukraine
  - Russia and Ukraine

  This includes the new RosUkrEnergo arrangements for delivering Russian and Central Asian gas supplies to Ukraine.

- Transparency in relation to flows at gas metering stations at the borders of Russia and CIS countries, and at the borders of CIS and EU countries. Information on such flows should be made available to European Commission officials in order to ascertain the availability of gas at these borders.[59] The situation which occurred between January 1-4 where Russia insisted that it was delivering contracted supplies to Europe to the Ukrainian border, and Ukraine insisted that gas was not being diverted from the transit pipelines, but EU countries were experiencing reduced gas flows, is not acceptable, and must not be repeated.
- Assurances from Russia and countries which transit Russian gas to EU countries – Ukraine, Belarus and Moldova - that they will provide early warning of any problems which they anticipate could arise in the transit of Russian gas to EU countries.

The obvious body to which the monitoring and enforcement of such tasks should be entrusted is the Energy Charter, given that the Energy Charter Treaty has been signed by all EU countries, Russia and CIS countries.[60] On January 3, the Secretary General of the Charter Secretariat sent a letter to the Russian and Ukrainian governments proposing, if a bilateral solution to the crisis was not reached, the use of the Energy Charter's "conciliation procedure" for resolution of transit disputes under Article 7, Paras 6-7 of the Energy Charter Treaty.[61] That conciliation procedure remains an option for the parties in any future dispute.

5. Summary and Conclusions

Despite most of the public commentary suggesting that the Russia-Ukraine gas crisis - precipitated by demands from Russia for a quadrupling of prices - had arisen without

[58] For background to the EU-Russia Energy Dialogue in relation to gas see: Stern 2005, pp. 134-5.
[59] On January 4, a Ukrainian website (http://ukroil.com.ua in Russian) reported that the Foreign Ministry had invited EU experts to verify gas flows through the country. On January 2, Gazprom announced that it had hired independent consultants to carry out this task.
[60]Russia and Belarus have not ratified the Treaty but are applying it provisionally.
[61] The full text of the Treaty can be found at: http://www.encharter.org/upload/9/120520674515751158192049714743532131935190860213f2543v3.pdf

warning over New Year 2005-06, the crisis had in fact been brewing for much of 2005 and arguably for several years previously. The rapid repudiation by the new Ukrainian Administration of the 2004 agreements (reached with a huge amount of effort) combined with the latter's refusal to allow Gazprom any ownership in the country's gas transportation and storage assets, or to move significantly towards (European) market prices for gas. Gazprom's motivation for taking such a hard line with Ukraine (and other CIS countries) was overwhelmingly economic. Gazprom and the Russian government are no longer prepared to provide gas at subsidised prices to former allies unwilling to make commercial concessions in the form of shared property rights to infrastructure. When the Russian stock market reopened after the New Year holiday, Gazprom's share price increased substantially reaching a record high, suggesting that investors had reacted positively to the crisis.[62]

There have been no reports that this four-day event caused any significant disruption of EU gas supplies. In any case, as far as the Russian side was concerned, its actions were not targeted at those countries. Nevertheless, for the Russian government and Gazprom the major lessons of the crisis must be that OECD governmental and media opinion is overwhelmingly that:

- Gazprom's contractual obligation is to ensure that full flows of gas are maintained to EU countries. Failure to meet that obligation, however caused, will call into question the security of Russian gas supplies.
- Any cuts in Russian gas supplies to CIS (let alone EU) countries will be interpreted in Europe and the US as being politically motivated, irrespective of the cause of the reduction, and the strength of evidence showing political motivation.

While many media commentators have suggested that the 4-day crisis should and will give rise to a fundamental rethink of European energy and security policy, such claims need to be treated with caution. It is not obvious that, following these events, European companies and governments will hurry to make alternative multi-billion dollar investments in energy supply infrastructure projects requiring 5-15 year lead times, with uncertain commercial outcomes. Perhaps when they need to make such investments, this event will weigh in their judgements, but memories will need to be very long, and commercial considerations very significant. Germany may be an important test case where, in an apparent immediate response to the crisis, Chancellor Merkel announced the need to draft a "national energy strategy".[63]

But should such events recur, the European response can be expected to be even stronger in relation to security of Russian gas supplies. A recurrence cannot be ruled out because of uncertainty that RosUkrEnergo will be able to guarantee the availability of around 56 Bcm of Central Asian gas at a price affordable to the Ukrainian market in 2006 and thereafter. Should availability fall short of such volumes, given the inability of Ukrainian buyers to afford Russian gas at $230/mcm, the Ukrainian response cannot be predicted with any confidence. Gas prices will continue to be a big problem, with Central Asian exporters believing they may be able to take a stance similar to Gazprom and raise prices significantly.[64]

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[62] Neil Buckley, Investors warm to Gazprom deal, *Financial Times*, January 11, 2006.
[63] *Merkel to plot energy strategy for Germany, Financial Times, January 7-8, 2006.*
[64] See note 41 above.

A more immediate consequence of this crisis is the paradigm shift in natural gas trade between Russia and its former Soviet allies. In 2006, Gazprom ceased to have any direct gas supply commitment to Ukraine except via RosUkrEnergo at a price of $230/mcm. Since it is unlikely that Ukraine will be able to pay such a high price, Gazprom will either save this gas or export some part of it to European countries either directly or through RosUkrEnergo.[65] While it has been suggested that Gazprom may gain up to $2.8bn in 2006 from the 2006 agreement, it is not possible to place a monetary value on the outcome until it is known how much of the 21 Bcm which Gazprom has saved will be sold and at what price.[66]

Elsewhere in the CIS, countries are being required to move rapidly to market-related prices, unless they are prepared to sell to Gazprom a significant equity share in their gas transportation assets. This will save significant volumes of gas – 20-25 Bcm/year in the Ukraine alone - at a time when Gazprom (despite its huge resource base) will need to make increasingly difficult trade-offs between the Russian domestic market and export markets.

With hindsight, January 1, 2006 may be hailed as a watershed in Gazprom's commercial strategy: a small, but highly significant, step towards a future in which Russian gas sales to CIS – including Russian domestic - customers become as profitable as (and with the saving of transportation costs potentially more profitable than) gas exports to Europe. In such a future, the issue of whether Europe is prepared to accept more Russian gas for security reasons, may be overtaken by whether Gazprom will find more profitable markets for its gas closer to home.

Glossary of units:
Bcm = billion cubic metres
$/mcm = dollars per thousand cubic metres

[65]This refers to the 15 Bcm of joint exports with Gazexport in the January 4 agreement, the destination of which is not clear.

[66] The figure of $2.8bn is from: *Expert: Ukraine vs Gazprom*, see note 17 above.