

# 3. RELATIONS OF UKRAINE AND RUSSIA IN THE ENERGY SECTOR

Ukraine-Russia relations in the energy sector have always been sensitive. Since the January 2006 gas crisis, they have become sensitive for the EU, too. There is a vast body of contracts in bilateral relations. However, performance of those contracts is highly selective.

The main intergovernmental contract in the gas sector is the Agreement between the Government of Ukraine and the Government of the Russian Federation on export of Russian natural gas to Ukraine and its transit across the territory of Ukraine to European countries of January 18, 1994; the basic agreement regimenting Ukraine-Russia relations in the oil sector is the Agreement between the Government of Ukraine and the Government of the Russian Federation on conditions of delivery of oil and petroleum products and their transportation across the territory of Ukraine of February 18, 1994.

The level of international agreements ensures some transparency in relations, since according to Article 21 of the Law of Ukraine “On International Treaties”, they must be published. This gives the public access to the text of such agreements and, respectively, financial-economic indicators of cooperation contained therein. However, since the second half of the current decade, the situation has changed fundamentally. Annual intergovernmental protocols for 2006-2008 were not signed, and relations in the field of transit of natural gas across the territory of Ukraine and its deliveries to Ukraine were regulated only on the level of business entities (“Gazprom” OJSC, “Naftogaz of Ukraine” NJSC, “Ukrgezenergo” CJSC, “RosUkrEnergo” company). This reduced the transparency of Ukraine-Russia relations in the oil and gas sector, since contracts between business entities are not published.

But the lack of transparency defaces the true picture. As a result, one cannot make the diagnosis and cure diseases in bilateral relations.

## 3.1. CURRENT STAGE OF COOPERATION

The trend towards deterioration of bilateral relations in the energy sector became evident after the approval of Russia’s Energy Strategy through 2020 in August 2003, whose Preamble expressly says: “Russia possesses significant reserves of energy resources and a powerful fuel and energy sector, being the basis of development of economy, **a tool of pursuance of home and foreign policy**”<sup>1</sup> (bold type – *Ed.*). Growth of oil prices on the world markets and monopoly of deliveries give rise to the temptation to use energy resources supplied from the Russian Federation to the CIS states as a tool for attainment of goals lying far beyond trade operations. It is not accidental that that timeframe evidently revealed trends previously not found in Russian trade in energy resources:

- limitation of gas deliveries to Belarus in February 2004;
- reduction of gas deliveries to Ukraine at the juncture of 2005-2006;

- limitation of oil deliveries to Belarus in January 2007;
- reduction of gas deliveries to Ukraine in March 2008;
- cut of gas deliveries to Ukraine and EU in January 2009.

As one may see from Table “*Dynamic of oil and gas prices*”, the desire of the Russian gas monopolist to boost its profit at any cost brought about growth of the price of gas supplied to Ukraine at a much higher rate than to the EU countries. And now, as the prices on the European market went down, “Gazprom” makes up for the decline in revenues in Europe at the expense of Ukraine and the CIS. As a result, it is losing the Ukrainian market because of too high prices. Hunt for European profits, starting from 2006, when the gas price on the European market exceeded that in the US (where gas prices traditionally had been higher than in the EU), in the end result leads to contraction of the market. And political risks associated with “Gazprom’s” behaviour prompt consumers to reduce, as far as possible, politicised and

<sup>1</sup> Energy Strategy of Russia through 2020 – Web site of the Russian Gas Society; <http://www.gazo.ru/dokumenty/es/index.khtml>



## Dynamic of oil and gas prices

Year	Average price of oil (Brent) on the European market*		Average price of Russian gas exported to the EU**		Price of gas delivered to Ukraine	
	\$/barrel	%, growth (+/-) to the previous year	\$/1 000 m <sup>3</sup>	%, growth (+/-) to the previous year	\$/1 000 m <sup>3</sup>	%, growth (+/-) to the previous year
2005	54.57	42.6	190.0	40.0	50.0	0.0
2006	65.16	19.4	260.7	37.2	95.0	90.0
2007	72.44	11.2	272.8	4.6	130.0	36.8
2008	96.94	33.8	471.9	72.9	179.5	38.3
2009***	44.43	-54.2	380****	-19.5	360.0	+100.5

\* Oil prices: U.S. Energy Information Administration – <http://tonto.eia.doe.gov/dnav/pet/hist/rbrteA.htm>

\*\* Russian gas prices: Official web site of “Gazprom” OJSC, [www.gazprom.ru](http://www.gazprom.ru)

\*\*\* 2009 – only in the I quarter.

\*\*\*\* Estimate by East European Gas Analysis – <http://www.eegas.com/Report-IFRS-2008r.htm>

unstable gas imports from Russia. The same is proven by the current statistics: gas consumption in the EU in January-February, 2009, fell by only 2.4% – while “Gazprom’s” exports in the 1<sup>st</sup> quarter fell by 39%<sup>2</sup>. The situation for Ukraine is no better, since reduction of consumption of Russian gas in the EU means reduction of transit and revenues of “Naftogaz of Ukraine”, against growing expenses.

One good development in bilateral gas relations was that the parties refused from the scheme employing a non-transparent mediator draining financial flows abroad.

Meanwhile, signing of a package of gas agreements for a 10-year period in January 2009, did not remove tension in relations between the two countries. The reason lies in the asymmetry of obligations and capabilities of the parties. “Gazprom” reached the European level of prices in relations with “Naftogaz of Ukraine”, retaining for itself the previous level of gas transit rates. Over the contract validity term, “Naftogaz of Ukraine” will face a threat of serious penalties for underconsumption of gas – while “Gazprom” bears no responsibility for undersupply of gas for transit. Furthermore, Ukraine is prohibited to re-export gas. Meanwhile, “Gazprom” obtained from Ukraine a colossal preference – ability for its 100% subsidiary to work on the domestic market. Such asymmetry is in fact discriminatory and inconsistent with partner principles.

### 3.1.1. Stereotypes of gas relations

“Since the breakup of the Soviet Union and till the present time, Russia has subsidised countries of the former Soviet Union by market prices of gas. The amount of those subsidies consists of the difference between the European price of gas and the below-market price set by “Gazprom” for consumers in those countries” – it is an extract from “Gazprom’s” presentation called to illustrate subsidising of Ukraine’s economy by the Russian monopoly at the expense of low gas prices<sup>3</sup>. According to official

“Gazprom” information, in 1994-2007, subsidies for Ukraine totalled \$34.23 billion. Meanwhile, in the heat of the gas crisis, Premiere V.Putin spoke of \$47 billion, which proves the manipulative character of those data. In reality, such “subsidising” was highly profitable for the Russian Federation, since it was accompanied with counter-subsiding – low transit rate and nominal rate of gas storage in underground gas storages. Even the present rate of gas storage makes, according to some estimates, only 4% of the European level<sup>4</sup>, being an unprecedented preference of Ukraine for Russian gas export, contrary to the WTO principles.

Another thesis – of “theft” of gas – is nothing but a propaganda move. The history of the Ukraine-Russia gas relations does not know a single **legal evidence** of those allegations. Moreover, there was only one known precedent when “Gazprom” officially went to court to prove a fact of “theft”. It was Case No.185/2000 in the International Commercial Arbitration Court at the Chamber of Commerce and Industry of the Russian Federation (Moscow) in “Gazprom’s” suit against “Naftogaz of Ukraine” NJSC for alleged unauthorised



<sup>2</sup> Discount not offered. – “Vedomosti” Internet publication, May 18, 2009, <http://www.vedomosti.ru/newspaper/article.shtml?2009/05/18/195950>

<sup>3</sup> Sergei Komlev “Is “Gazprom” a Threat to European Energy Security. Myths, Assertions and Facts”. – Presentation, Bratislava, (October 27, 2008), slide 10.

<sup>4</sup> Gas price for Ukraine and future problems. – Web site East European Gas Analysis, <http://www.eegas.com/ukr090120r.htm>

siphoning of gas on the territory of Ukraine. On May 30, 2001, the court dismissed the suit on the ground that the contract between “Naftogaz” and “Gazprom” contained an article regimenting above-contract recovery of gas, which legally could not be viewed as unauthorised recovery (theft). During the latest gas crisis “Gazprom”, speculating on the thesis of “theft” of gas on the territory of Ukraine, tried to present use of fuel gas as a fact of theft. This was not confirmed by an international monitoring group. It is high time to give up such approaches. They are of use to no one – neither Russia nor Ukraine. And the EU develops a reserved attitude to both states whose non-transparent relations in the gas sector are seen as a challenge to the EU. It does not matter who is to blame – Russia or Ukraine. Brussels identifies it as a “problem of deliveries from the East”.

### 3.1.2. Ukraine’s transit role

The Russian Federation is trying to nullify the transit role of the Ukrainian GTS for delivery of Russian gas to the EU. In fact it tries to build a system of gas pipelines by its capacity equal to the present Ukrainian. Such an objective may be set, but its implementation is highly improbable, since “Gazprom” does not have the required technological and financial potential. Even if we hypothetically assume that the “Nord Stream” and “South Stream” projects are implemented and Russia can meet growing needs of the EU in natural gas, even in that case Ukraine’s role of a transit link will persist. The transit role of the Ukrainian GTS may be reduced only in three cases:

- **“Crisis of deliveries”** – collapse of gas extraction in Russia (old deposits of West Siberia are exhausted, Yamal and Shtokmanovskoe projects are not developed, despite much ado, as in 1990s);
- **“Refusal from imports”** – refusal of the EU to increase gas imports from Russia or even their reduction, replacement of gas piped from the Russian Federation with liquefied natural gas from other countries;
- **“More pipes than gas”** – construction by the Russian Federation of “Nord Stream” jointly with Germany, and “South Stream” – with Italy, in the conditions of decline of gas extraction in Siberia, as Russia will have more pipeline capacities than gas for transportation.

### 3.1.3. Relations in the oil sector

Compared to the much publicised events in the gas sector, oil relations receded into the background. They, however, have bottlenecks of their own. Reverse operation of the Odesa-Brody oil pipeline did not increase oil transit via Ukraine, although this argument was used by Russian companies in discussions of 2003-2004. Oil flows were just redistributed, that is, the reverse route absorbed the flows previously piped by the Dnieper oil pipelines system. Russian suppliers can save through the reverse use of the Odesa-Brody pipeline only in case of dumping rates of “Ukrtransnafta”.

The jump of transit in 2007 was an exception caused by the unprecedented (almost 50%) reduction of the transit rate and cost of handling services at Pivdennyi terminal, proving that reverse means not additional volumes of oil, but those redistributed from another transit line (Table “*Volumes of transit via Ukraine’s oil transportation system*”).

Volumes of transit via Ukraine’s oil transportation system, million tons/year					
2003	2004	2005	2006	2007	2008
33.2	32.4	31.3	33.2	39.7	32.8

Since 2005, Ukrainian proposals of interaction within the framework of the Odesa-Brody project, **customarily** seen as a threat for Russian oil in Europe, are waiting for a response. For example, it proposed transportation of **additional** 9 million tons of Russian crude by a shorter and more economic for Russian oil companies route Samara-Kremenchuk-Pivdennyi instead of the reverse route Samara-Unecha-Mozyr-Brody-Pivdennyi. Furthermore, **routes offered with commissioning of the Odesa-Brody pipeline would give Russian companies access to South German and Austrian refineries, if the Russian Federation opts to transport low-sulphur Russian oil shipped from Tuapse.**

### 3.1.4. Relations in the nuclear sector

If relations in the nuclear sector employ a model similar to the gas sector, nothing good will go out of that. Russia painfully reacts to the Ukraine-U.S. cooperation in that sector, seeing a political dimension there, although Ukraine demonstrates first of all commercial approaches intended to create a competitive environment and improve the pricing policy of partners supplying nuclear fuel on a long-term basis. If the parties manage to sign a long-term agreement of delivery of fuel resting on mutual respect of interests rather than an attempt to preserve the supplier’s monopoly, this will bring real progress.





Russia has already got a new preference from Ukraine, since a Russian contractor will build two new power units at Khmelnytskyi NPP. But Ukraine is interested in creation of its own incomplete nuclear fuel production cycle. Proposals of the Russian side in that sector pursue conservation of the present state of affairs – domination of “TVEL” company. What is good about the U.S. proposals is that they pursue, in the end result, mainly self-sufficiency of nuclear fuel for Ukrainian NPPs. At that, the US proposals are not aimed at full exclusion of cooperation with Russia – while the Russian ones clearly demonstrate a desire to isolate Ukraine from cooperation with the USA and EU in that sector.

### 3.2. PROSPECTS AND LINES OF COOPERATION

According to reports, Russian President D. Medvedev on a visit to Finland proposed a draft of the new Energy Charter. Among other things, it presumed creation of a new system of legal acts in the energy sector. According to the project authors, it should be:

- universal (applicable to relations between any states);
- open (accessible for third countries);
- all-embracing (covering all sides of interaction in the energy sector);
- equal and non-discriminatory (without disparities to the benefit of separate categories of participants);
- not contrary to existing obligations under other international documents;
- effective (to include a workable joint mechanism of implementation)<sup>5</sup>.

Those provisions may be called guiding, first of all, for Russia itself. It is important that declaring such approaches, the Russian Federation itself begin to respect them. Otherwise it will look as a policy of dual standards, where everybody plays by commonly accepted rules, and Russia – with the rules.

With account of the consequences of the gas crisis for Russia, Ukraine and the EU, and to avoid similar situations

in the future, the parties should propose a European Energy Transparency Initiative – to provide transparency of the entire production string “extraction – transportation – consumption”. They should guarantee mutual access of consumers, suppliers and transmitters to information in all links of the production string, from the well head to the consumer’s flange. The consumer has the right to know how much resources is extracted and pumped to the supplier’s pipeline for transportation, how much goes out of the transit system, how much actually goes to the consumer, as well as the prices, rates, idle pipeline capacities and so on.

It is similarly expedient to initiate creation of an on-line communication system among the control centres of “Gazprom”, “Naftogaz of Ukraine” and European companies (SPP in Slovakia, PGNiG in Poland, MOL in Hungary, “Transgas” in Romania), showing **real time** movement of all gas: admission to the Integral Gas Supply System of the Russian Federation; movement along the main gas pipelines of Russia, Ukraine, Belarus, Moldova; delivery of gas to the EU territory at the concerned gas measuring stations. It will be a test of readiness to work by the rules of transparency for all participants of the production string. This would also be consistent with at least two principles declared by the Russian Federation in the draft of the new Energy Charter:

- transparency of all segments of international energy markets (production/export, transit, consumption/imports);
- creation and perfection of mechanisms of early warning involving suppliers, consumers and transit states<sup>6</sup>.

These and other provisions of the presented draft of the Energy Charter may be discussed only after the Russian Federation completes all procedures under the present European Energy Charter, i.e., its ratification. The true, not declarative good will of Russia would be demonstrated by the refusal from asymmetry in contractual obligations of “Gazprom” and “Naftogaz of Ukraine”. After that, the subject of the gas transportation consortium might be discussed again. Russia’s activity concerning the “South Stream” makes Ukraine once again demand from “Gazprom” additional guarantees and performance of obligations<sup>7</sup>.

<sup>5</sup> Conceptual approach to the new legal framework of international cooperation in the energy sector (goals and principles). – Official web site of the President of Russia, April 21, 2009, <http://www.kremlin.ru/text/docs/2009/04/215303.shtml>

<sup>6</sup> See: Conceptual approach to the new legal framework of international cooperation in the energy sector...

<sup>7</sup> The following should be noted. Clause 60 of Russia’s National Security Strategy says: “The core of the energy security lies in steady satisfaction of demand with sufficient quantities of energy resources of a standard quality, **effective use of energy resources through enhancement of the competitiveness of national manufacturers, avoidance of possible deficit of fuel and energy resources**” (see Strategy of National Security of the Russian Federation through 2020, <http://www.scrf.gov.ru/documents/99.html>).

In this context, access of independent Russian gas producers to foreign markets seems logical, since they show a positive dynamic of gas extraction, by contrast to the stagnant and downward dynamic of “Gazprom”. For instance, “Rosneft” hopes that as soon as in 11 years, its gas production will amount to 55 BCM. In 2008, it extracted 12.5 BCM of gas (see: Gas ambitions of “Rosneft”. – “RBC Daily” Internet publication, May 14, 2009, <http://www.rbcdaily.ru/2009/05/14/tek/414202>).