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Ukraine's imports of Russian gas: how a deal might be reached

Executive Summary

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The current gas dispute between Russia and Ukraine is potentially the most serious yet. It takes place against the background of the two countries' deteriorating relations following the collapse of the Yanukovich government, the annexation of Crimea by Russia and the military conflict in eastern Ukraine. In June, negotiations between Russia and Ukraine on the pricing of gas imported to Ukraine broke down, gas deliveries were halted, and Gazprom (the exporter) and Naftogaz Ukrainy (the importer) began arbitration proceedings against each other.

The main obstacle to agreement on gas issues is political. Throughout the post-Soviet period, commercial agreements between Gazprom and importing companies in Ukraine were underpinned by inter-governmental agreements (IGAs). From 2006, contracts were signed without specific reference to IGAs, but the Russian and Ukrainian governments continued to participate in discussions of gas import and transit, and corporate negotiations were conducted alongside political negotiations. This year, political relationships have come close to breaking down, and the European Commission, concerned at the possible impact of a Russia-Ukraine dispute on the transit of Russian gas to Europe, has joined three-sided negotiations on the unresolved gas issues. By mid-June these had come to a standstill.

This paper concludes that the original terms of the 2009 contract between Gazprom and Naftogaz are unsustainable, given the changes in the relationship between Russia and Ukraine (resulting in the removal of political compromise mechanisms that have been used in the past) and the changes in the European gas market (which have affected prices and pricing formation in other Gazprom export contracts). Over the next year, the "market price" for up to 15 bcm/year of gas imports into Ukraine could be formed on the basis of a combination of reverse flow prices (NCG plus transportation) and coal switching prices. European netback methodology, as described above, might also be used.

A pragmatic short-term commercial solution to the current crisis could be for Naftogaz to pay the total of debts that it acknowledges, for gas delivered prior to 16 June 2014; to restart imports at $268.50/mcm; and to leave the price of gas deliveries from April 2014 onwards to be decided by the arbitral tribunal.

In the longer term, further movement away from the previous Russia-Ukraine bilateral commercial relationship, and towards a more direct influence of market mechanisms, seems likely. Gazprom would be faced with decisions about whether it wished to compete for Ukrainian customers against reverse-flow supplies from Europe and new Ukrainian domestic production. As for contractual

arrangements, the probable framework for imports by Naftogaz remains the 2009 contract, amended by negotiation – assuming that the political situation allows them to resume. Towards the end of the decade, and certainly after 2019, and depending on the progress of Ukraine's discussions with the EU on integration into European energy markets, gas sold on Ukraine's eastern border could be bought by a range of companies, including some who would resell it to customers in the EU.

About the Author

Simon Pirani is Senior Research Fellow on the OIES Natural Gas Research Programme. Before joining the Institute in 2007 he wrote about Russia and Ukraine as a journalist and historian. He is the editor of Russian and CIS Gas Markets and their Impact on Europe (OIES/OUP, 2012) and author of many publications on Russian, Ukrainian and Central Asian gas issues.