

Ukraine: the end of post-Soviet gas pricing

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In 2015, Ukraine's gas import prices have been pulled down by the effects of sustained low prices in Europe and the expanding reverse flow trade. The military crisis and soured relations with Russia have effectively finished off the post-Soviet method of setting prices by bilateral, politically influenced, negotiations. In the domestic market, shock therapy has been applied: households' gas tariffs were hiked by 280 per cent on average, in April. Whether and how such reforms will work remains to be seen.

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'UKRAINE'S GAS MARKET HAS SHRUNK SUBSTANTIALLY IN RECENT YEARS ...'

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The background

Ukraine's gas market has shrunk substantially in recent years – from 70–75 bcm/year in the mid 2000s, to 50.4 bcm in 2013, 42.6 bcm in 2014, and down further in early 2015 – but even now it is one of Europe's largest. The country has steadily produced about 20 bcm/year, but otherwise

has depended on Russian imports – payment (or non-payment) for which has long caused friction.

For several years up to 2005, Ukrainian import prices were fixed at \$48–50/1000 cubic metres (mcm). After the Russo-Ukrainian 'gas war' in 2006 – when Gazprom responded to mounting debts by reducing supply, and flows to European destinations were interrupted – Russia argued that Ukraine's import prices should be linked to those in Europe. Kyiv agreed, but in subsequent years, rapidly rising oil prices made that target hard to achieve. Ukraine's import prices bounded up to \$179.50/mcm by 2008 – but in that year they were still less than half the oil-linked prices Gazprom received in Germany.

After the second 'gas war' of 2009, a contract with European-style oil-linked prices was signed between Gazprom and the Ukrainian state importer, Naftogaz Ukrainy. But in Europe the economic recession, combined with market liberalization, resulted in a progressive move to hub-based prices, and a gap opened between the latter and Gazprom's oil-linked

prices. European buyers demanded, and began to receive, discounts from Gazprom.

Ukraine got its discount (\$100/mcm on import prices, from April 2010) not from Gazprom but from the Russian government, in exchange for extending the lease on the Black Sea naval base. But as oil prices rose remorselessly, prices in Ukraine's import contract followed them upwards, and in both 2012 and 2013, Ukraine's import prices, even with the discount, slightly exceeded the BAFA average German import price.

After the political crisis

In the spring of 2014, when the Yanukovich government fell, Russia annexed Crimea, and military conflict erupted in eastern Ukraine, the 2009 contract effectively ceased to function. (It is now subject to numerous arbitration cases, which will begin to be heard next year.) It has been replaced *de facto* by competition between Russian imports (prices of which have been agreed in trilateral political

Ukraine gas price vs European prices, 2006–14, \$/mcm

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Import price*	95.0	130.0	179.5	198.3	256.7	313.5	425.9	413.5	295.0
BAFA average German import price	295.5	300.0	435.3	320.2	301.2	393.7	410.2	402.5	341.6
TTF	275.2	223.7	402.7	183.6	252.8	346.2	363.7	395.3	310.3

* Russian import price 2006–13; average import price 2014.

Sources: German economy ministry; TTF; companies

Gas consumption in Ukraine 2014

	<i>bcm</i>	%
Industry and power sector	15.7	37
Residential and public sector	15.8	37
District heating	7	16
Technical gas	3.7	9
'Uncontrolled territories'	0.4	1
Total consumption	42.6	100

Source: Naftogaz Ukrainy

Industry and power sector demand in 2014 was at 46 per cent of its 2007 level. This is not surprising given that: the separatist-controlled area includes the heaviest concentration of industry and accounts for an estimated 9 per cent of GDP; in 2014, trade with Russia was at one third of its 2013 level; and in 2014 industrial output and construction fell by 11 per cent and 22 per cent respectively year on year. (They were down a further 22 per cent and 31 per cent in Q1 2015.) All of this means that, notwithstanding emergency regulations over the winter months (compelling large industrial customers to buy from Naftogaz rather than private traders) the state company's income from these customers has fallen.

Residential customers pay for Ukrainian-produced gas at prices that have always been heavily discounted; an even greater loss has been borne by Naftogaz on sales to district heating companies, who buy imported gas at low prices. (This is not the end of the black hole in Naftogaz's finances: in 2014 the IMF reckoned that 'inability to collect domestic receivables' (\$2.05 billion) and 'net sales shortfall' (\$890 million) comprised about half of the company's total operational deficit of \$5.5 billion.)

On 1 April the government, guided by the IMF towards classic 'shock therapy', raised regulated tariffs for residential customers by an average of 280 per cent (roughly – one group of customers now pays \$333/mcm, and a

larger group, entitled to discounts, pays \$167/mcm). Tariffs for district heating companies rose by 129 per cent to \$139/mcm. Naftogaz's team of reform-minded managers launched a feisty campaign against non-payment: they published a list of big non-payers among district heating companies (whose debts totalled \$1 billion in late April); appealed a court ruling that prevented them cutting off non-payers; offered non-payers who own gas producing companies a swap deal; and secured parliamentary approval to sell on debts.

Tackling non-payment by residential customers will be much harder, mainly because protection for poor families (that good practice requires is arranged prior to increases) is patchy. Prime Minister Arseniy Yatseniuk says the number of families entitled to subsidies for gas will rise to 3 million. But past experience across the whole former Soviet Union shows that local authorities will probably take some time to put schemes in place, and that households will probably prioritize other necessities before they pay for gas.

Outlook

Ukrainian advocates of gas supply diversification have suggested that reverse flow gas, together with higher domestic output, could replace Russian imports completely; the government has instructed Naftogaz to limit imports to no more than 50 per cent from a single source (i.e. Russia). Like the

analogous Russian claims – that new pipelines to Europe (Nord Stream, Turkish Stream, etc.) could reduce gas transit across Ukraine to zero – scenarios with no Russian imports at all would probably be relevant only in the unlikely event that political relationships deteriorate even further, for example if Russia and Ukraine declared war on each other.

The more likely outcome – a 'frozen conflict' in eastern Ukraine for many years, with Russian-supported separatism weakening the economy and government – will motivate both sides to reduce the Russo-Ukrainian gas trade to a minimum, but not to halt it completely. In this case, reverse flow deliveries will compete on price with direct Russian imports, as they have done this year. The benefit to Ukraine will be all the greater if, as it appears, we are entering a relatively long period of lower oil and gas prices.

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Domestically, market reforms are likely to continue. But only after the economy starts to recover from its collapse will it be possible to estimate how much gas demand will return at post shock-therapy prices.

Finally, Ukraine is likely to lose its status as a major gas transit country. Gazprom says that, once the current transit contract expires at the end of 2019, it intends to divert volumes for European customers via Turkey, Poland, or Nord Stream. Opinion as to whether some of those customers will wish, or be able, to buy Russian gas on Ukraine's eastern border and arrange transit themselves is divided. All that is sure is that the post-Soviet order, in which transit issues were always linked to Ukrainian import issues in quasi-political negotiations, is coming to an end.

