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The Gazprom-Ukraine Gas Dispute of January/February 2006 and Energy Security

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June 12, 2006

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Research Work from the Gas Programme

RECENTLY PUBLISHED:

- The Gas Exporting Countries Forum – is it *really* a gas OPEC in the making? Hadi Hallouche*
- Egypt's Domestic Gas Industry, Randa Alami*
- The Russian-Ukrainian Gas Crisis of 2006, Jonathan Stern*
- Future Gas Demand in Europe – the importance of the power sector, Anouk Honore*
- Gas Prices in the UK: markets and insecurity of supply, Philip Wright, Oxford University Press, 2006
- The Future of Russian Gas and Gazprom, Jonathan Stern, Oxford University Press, 2005

FORTHCOMING:

- The New Security Environment for European Gas, Jonathan Stern
- LNG Demand in Europe – consequences of price arbitrage, Anouk Honore

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Background and Origins: Russia-Ukraine gas relations

- **Transit relationship**
- **Sales relationship**
- **2004-05: from settlement to crisis**

This crisis did not suddenly appear on January 1, 2006

Gazprom and Ukraine Gas Relations - 2004

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The 1990s were a very bad decade. The July/August 2004 Agreements established:

- Long term sales and transit framework agreed
- Post-Soviet debt settled by Gazprom advance transit payment deal
- Long term JV for shipping of Turkmen gas established - RosUkrEnergo
- Serious intention to establish Russian-Ukrainian "Consortium" to refurbish/own /operate transit capacity

2004 relationship was the best since Soviet times

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Gazprom and Ukraine under the Yushchenko Administration - 2005

- March/April: Yushchenko "repudiates" August 2004 agreement, suggests moving to "European" prices for sales and transit
- May: 7.8 Bcm of Gazprom's gas in Ukrainian storages goes "missing"
- June: Consortium concept abandoned

Second half of the year:

- Negotiations make no progress towards Russian demands for "market" prices
- Gazprom and Naftogaz Ukraine signed new contracts for Turkmen gas in December 05

Clear "signposts" to January 2006 crisis

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The January 1-4, 2006 Crisis

JANUARY 1:

- Gazprom publicly cuts off gas to Ukraine (continues contractual volumes to Europe)
- Europeans immediately report reduced deliveries of Russian gas

JANUARY 2-3:

- Gazprom reports that 105mmcm and 119mmcm disappear in Ukraine on these days
- Russian deliveries to Hungary 40% down, Austria, Slovakia, Romania (30%), France 25-20%, Poland 14%, Germany (not known)
- January 2: Gazprom agrees to pump an additional 95mmcm through transit network; January 3: Austrian and Hungarian supplies return to normal

JANUARY 4:

- Gazprom/RosUkrEnergo agreement reached
- European deliveries return to normal

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The January 4, 2006 Agreement

- Gazprom to pay Naftogaz \$1.6/mcm/00km for transit in cash
- RosUkrEnergo (RUE) will deliver all gas to Ukraine from Russia and Central Asia (no re-exports of Russian gas!)
- RUE/Naftogaz JV will market all gas in Ukraine
- RUE will have 72 Bcm of available gas: 41Bcm Turkmen, up to 15 Bcm (8 Kazakh, 7 Uzbek), 17 Bcm of Russian gas at \$230/mcm
- RUE/Naftogaz JV gas sales: do not allow re-export
- 15 Bcm to be exported in a "joint programme" with Gazexport

Cash payments for transit and gas (end of barter trade)

The February 3, 2006 Agreement

- New JV UkrGazEnergo established, 50/50 RUE/Naftogaz
- UkrGaz-Energo and Naftogaz will supply industrial market (Naftogaz will retain residential market)
- RUE will supply UkrGazEnergo with
  - 32 Bcm in 2006 at $95/mcm for the first six months
  - 58 Bcm in 2007
  - 60 Bcm during 2008-10
- 5 year transit contact at $1.6/mcm/00km in cash separated from supply contracts

Pricing will depend on trends in Central Asian gas prices

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Cold Weather: January/February 2006

- **Temperatures fell to -55c in Siberia, down to -37c in Moscow, minus 20-30c in east/central Europe**
- **Difficulty in maintaining supplies of Russian gas to Europe:**
  - **During January, Ukraine took 550 million cm (up to 80 mmcm/day) of European gas supplies = $52-138 million**
  - **Shortfalls in nominated (contracted?) volumes of Russian gas: Poland 34-36%, Hungary 20-25%, Italy up to 16%, Austria 10% - Italy still short in early March**

Coldest weather in western Russia for more than 60(?) years

The Crisis: gas security consequences

January 1-4:

- **mild weather in Europe and most countries still on holiday – so reduced energy/gas demand**
- **some inconvenience caused in European countries; no “crisis” but extreme nervousness**

The January/February Cold Spell:

- **without Ukrainian diversions, Gazprom would probably have met all European nominations**
- **performance of Russian gas (and power) infrastructure in extreme low temperatures was miraculous**
- **security questions need to be asked in some European countries, but not in Russia**

January/February was not a <u>gas supply</u> crisis

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Political and Media Reaction: uniformly negative

- "An obviously political motive": Condoleeza Rice
- Use of energy as "a tool of intimidation and blackmail": Dick Cheney
- "Europe must reduce dependence on Russian gas" FINANCIAL TIMES
- "Russia's use of energy as a political weapon could prove disastrous" THE TIMES
- "Russia's treasured image of reliability has been severely tarnished" GAS MATTERS

General Conclusion: Russia is prepared to use gas as a political weapon in Europe

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Russia Actions: Politics or Money?

Russian determination to enforce new commercial terms:

- **in response to Ukrainian determination to reorient towards EU/NATO, combined with refusal to allow Gazprom to own gas assets**
- **for all CIS countries, given the opportunity cost of supplying gas with European prices at record levels; decisive break with the Soviet past**
- **similar to Russian demands from East European countries in 1990-91 following the break-up of CMEA**

Politics <u>and</u> Money!

Unresolved Gas Questions and Consequences

- What really happened in terms of gas and transit flows on January 1 and 2, 2006?
- What was the role of the Turkmen President in signing contracts with both Gazprom and Naftokhaz Ukrainy on December 29, 2005:
    - what were the contractual commitments for 2006?
    - were those commitments clearly impossible to deliver?
- Has the ownership of RosUkrEnergo (RUE) been definitely established?
- Pricing of Russian and Central Asian gas to CIS countries: what should the principles be?

Crisis has created a new era for Russia/CIS gas trade

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Gas Security Lessons for Europe

Few other than those which have been constantly repeated in the IEA/EU literature:

- **over-dependence on a single source, or transit route is unwise**
- **all parties need to be part of international dispute resolution procedures eg ECT Transit Protocol**
- **storage provision needs to be re-examined in some countries**

Gazprom response to transit uncertainty has been transit-avoidance pipelines eg Yamal, Blue Stream, North European Pipeline

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Crisis Overspill: IEA/EU versus Gazprom

IEA/EU CONCERNS:

- lack of network liberalisation/TPA for independent producers
- Under-investment in supply
- lack of Energy Charter Treaty (ECT) ratification

GAZPROM RESPONSES:

- Outsiders will not dictate to us about the organisation of our industry
- We will meet all of our commitments
- Crisis has shown that ECT is not up to the task

Dialogue of the "moderately" deaf?

OVER-REACTION FOLLOWS OVER-REACTION: Russian and OECD gas discourse descends to "Megaphone Diplomacy"

- European politicians suggest limits on Russian gas supply to – and Gazprom investment in - Europe
- Russian politicians react by saying that "other gas export markets" (ie China and US) are available
- European media reacts by accusing Russians of "threatening to divert" supplies from Europe to other markets

All of this is irrelevant in short/medium term <u>gas</u> relations, but is symptomatic of a downward spiral in <u>political</u> relations

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Potential Longer Term Consequences of These Trends

After the two North European pipelines – bringing Russian export capacity up to 200-250 Bcm (~160 Bcm in 2005) in the late 2010s – a limit on exports may be reached:

- **from the European perspective because of fears of over-dependence (and worsening political relations with Russia)**
- **from the Russian perspective because of:**
  - ***general tightening of Gazprom's supplies***
  - ***future profitability of the Russian market may make European exports less attractive***

Should this happen: consequences for the European gas market will be significant