Ukraine's gas loop

by Nicu Popescu

For many years, most countries in central and eastern Europe - from Bulgaria to Latvia, from Ukraine to Hungary - have complained of their dependence on Russian gas. All have tried to reduce this dependence through a combination of the development of new infrastructure (interconnectors, compressor stations for reverse gas flow), frantic searches for alternative gas suppliers (Nabucco, Norway), anti-trust procedures against Gazprom (as launched by the European Commission), and regulatory changes affecting the sale of gas in Europe (the 'third package').

An interesting sideshow of this struggle is now occurring in Ukraine. While most analysts assumed that a decreased dependence on Russia would come from access to non-Russian resources - in the form of shale gas, liquefied natural gas (LNG) or Norwegian gas - Ukraine and the German energy giant RWE seem to have found a way to limit Gazprom's sway over Kiev, while continuing to consume Russian gas.

The gas game across central Europe

Russia's energy leverage traditionally came not just from being a major gas supplier, but also from a set of other instruments which strengthened its bargaining power, such as different pricing for different markets (market partitioning), destination clauses (limiting the reselling of gas), or take-or-pay provisions (locking partners into long-term arrangements). It is now interesting to see how some of the same instruments that were once used to consolidate Russian influence have been turned against Gazprom: by the logic of the market, by some of Gazprom's German partners, and by Ukraine itself.

Gazprom usually includes 'take or pay' clauses in deals with its European buyers. Under these clauses, the buyer must pay for a minimum amount of gas even if it is then not consumed. Due to the economic crisis, however, consumption of Russian gas has fallen significantly, in the EU as well as in Ukraine. As a consequence, many of Gazprom's partners have ended up paying for more gas than they need in the current economic downturn. In addition, unlike Ukraine, most big EU companies buying Gazprom gas managed to obtain (through negotiation and arbitration) significant discounts in the last few years. Gazprom also engages in a practise known as 'market partitioning', charging higher prices where it is has a complete monopoly (in Ukraine for example) and lower prices in countries where it is less dominant. The result is that, while the average price charged to European consumers is around $370 per 1,000 m3 (a reduction of approximately 6 per cent from last year), Ukraine pays $420, even after receiving a $100 discount for agreeing to host a Russian naval base in the Crimea until 2042.

The combination of take-or-pay deals and market-partitioning has created a situation whereby

Gazprom's European partners possess a surplus of Russian gas which offers a cheaper alternative to the gas directly supplied to Ukraine by Gazprom. This provides a strong incentive for Ukraine to buy any (even Russian) gas from Europe. And European companies, in theory, also have an incentive to sell such gas to Ukraine.

The German energy giant RWE seized on this opportunity in November 2012, and began to supply gas to Ukraine via Poland and Hungary. These supplies reached a monthly volume of 120 million cubic metres last April (compared to Gazprom's 800 million cubic metres supplied in the same period) and now make up around 13 per cent of Ukrainian gas imports. Although this figure is still relatively small, it is certainly not negligible either. RWE then agreed to deliver yet more gas to Ukraine via Slovakia, a country with greater pipeline capacity. There is also talk of Ukraine receiving up to 16 billion cubic metres (bcm) of additional gas from the EU (roughly half of what Gazprom is set to supply Ukraine in 2013), an amount which would fundamental alter the energy politics of the country.

The paradox of the Ukraine-RWE partnership is that the gas in question is mostly of Russian origin; by being re-routed via the EU, however, Ukraine benefits from both lower prices and greater freedom *vis-à-vis* Gazprom.

A contested case

Gazprom cried foul, and in March 2013 it denounced a 'dubious deal' that it likened to a 'swindler's scheme'. Gazprom's objections stem from the fact that RWE buys gas at a lesser price, and then with the same (Russian) gas undercuts the company's sales (and position) in Ukraine. This is technically true, as the Ukraine-RWE plan seems to be for Russian gas to cross the EU border into Slovakia) from Ukraine on three large pipelines - where it becomes property of RWE as the buyer - and for it to then be immediately turned back on a large fourth, reverse flow pipeline into Ukraine through what Gazprom calls a *zakoltsovka* ('ringed' pipe junction).

RWE has responded by arguing that that it buys gas from several sources, and as it provides gas to Ukraine from its overall energy mix, it cannot be accused of selling 'Russian' gas. It also argues that, even if part of its energy portfolio were originally from Russia, this is a moot point, since once RWE has bought gas from any supplier, be it a country or a company, RWE is entitled to do whatever it likes with it. Just a few years ago, this would not have been possible, since major energy companies had destination clauses written into their contracts preventing the re-sale of gas. But following an EU drive to prohibit destination clauses, having identified them as an anti-competitive practice, they are largely a thing of the past.

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Both Gazprom and RWE have valid points. But ultimately it is the use of market-distorting practices and the subsequent market counter-strike effect that lie at the heart of the problem. In other words, it is Gazprom's own practice of different pricing strategies and its fondness for take-or-pay clauses that created both supply and demand for the Ukraine-RWE scheme.

Such an arrangement is probably neither a long-term nor a sustainable solution for Ukraine's energy woes. Were gas consumption in the EU to increase, for example, Ukraine would then not be among the priority consumers for EU gas suppliers. Gazprom could put greater pressure on Ukraine for not buying sufficient Russian gas directly under the take-or-pay arrangement. More importantly, Gazprom is trying even now to block the transportation of RWE gas to Ukraine via Slovakia in its capacity as an operator of the Ukrainian segment of the pipeline used to transit gas to the EU. It is fair, therefore, to say that a showdown between Ukraine and Gazprom over this issue is in the pipeline.

Yet the tensions in the Ukraine-RWE-Gazprom triangle are indicative of the increasing integration of Ukraine into European energy markets, something which will only accelerate if Ukraine further implements the EU energy *acquis* (including the 3rd energy liberalisation package). The battle for supplying gas to Kiev also curiously shows how the once powerful monopolistic strategies of Gazprom - take-or-pay clauses, market partitioning and destination clauses - have either been neutralised or even turned against the company through the logic of the market and the regulatory power of the EU.

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