

# Russian – Ukrainian Gas Dispute: Prices, Pricing and the ECT\*

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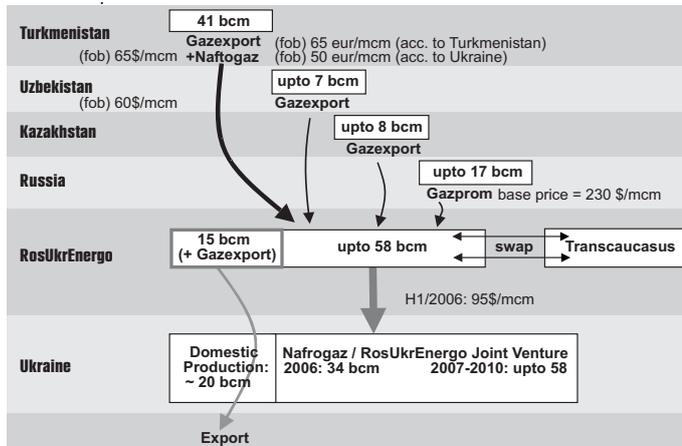
The Russian-Ukrainian gas dispute of late December 2005 – early January 2006 and related events have generated a lot of international attention and comment, most often concentrating on political or geopolitical considerations arising from this dispute. The Energy Charter's perspective on this dispute is on broader (multilateral) and longer-term issues of energy security, and focuses on energy-specific economic, legal, technical and policy risks, and on how these risks can be mitigated, including through the application of international legal instruments. This perspective on the Energy Charter's potential role improved during the resolution of the dispute.

This year, the Energy Charter undertakes a special study on the development of international pricing mechanisms for oil and gas. The author is prepared to make a few preliminary comments on the pricing issues relevant to the dispute now, however.

The centerpiece of the dispute's resolution was the replacement of the existing barter arrangement (with politically motivated and mutually inter-linked levels of transit fees and export prices) with a contractual separation of transit and supply flows. Prior to the January 4th, 2006, agreement Russia was paying Ukraine notional transit fees equal to 1.09 USD/mcm/100km for transit of its gas to Europe (approximately 110-120 BCM/year). This payment was made in kind by gas at the notional purchase price of 50 USD/mcm. The balance of the gas owed to Ukraine was supplied by Russia at the same notional price.

According to the January 4th agreement, transit fees are to be paid in cash at 1.6 USD/mcm/100 km. All gas to Ukraine from Russia will be supplied by RosUkrEnergO (RUE) company, whose gas balance would present a mix of gas volumes: from Gazprom (sold to RUE at the price 230 USD at Russian-Ukrainian border), and also from Central Asian states to RUE, at much lower prices, at the borders of those gas-producing states. Thus will Ukraine receive gas at a lower average price, by RUE as operator of these supplies – at 95 USD/mcm for the first half of 2006<sup>1</sup> (see diagram 1).

Diagram 1. Schematic of the 4 January 2006 Agreement



Energy Charter member states want to develop open and competitive energy markets, which is impossible without establishing fair, transparent, market-based pricing mechanisms, leading to fair and transparent prices. Two central topics of

the dispute were transit and supplies, and in particular, the level of transit fees and export prices. Analysts commenting on the dispute said much less about pricing.

## Interdependence: multilateral implications

These events demonstrate, yet again, the growing interdependence of producers, consumers and transit countries, and that bilateral disputes can very quickly embroil multiple parties. This has underlined the rationale for the Energy Charter as a multilateral framework for promoting reliable energy supply and transit.

\* Based on author's presentation at the Workshop organized by Centre for European Policy Studies on "Security Implications of Russian Energy Policy", Brussels, CEPS, January 27, 2006.

<sup>1</sup> The details of the dispute – its history and results, are best presented in: Jonathan Stern. The Russian-Ukrainian gas crisis of January 2006. – Oxford Institute for Energy Studies, 16.01.06, www.oies.org.

The parties directly involved in the dispute (Russia, Ukraine, European Union) have been addressing the Energy Charter (both in its political and legal dimensions – as the multilateral rule of law) as a possible framework for resolution. Russia and Ukraine were ready to consider the Energy Charter Secretary General's proposal of January 3<sup>rd</sup> to use the Energy Charter Treaty (ECT) conciliatory procedure of transit dispute settlement (established by Art. 7 of the ECT), in case they could not find a bilateral solution to the dispute. Fortunately, a bilateral compromise was reached the next day.

In his January 4<sup>th</sup> interview with the BBC, Andris Piebalgs, the EU Energy Commissioner, answered the question "What can be done to make sure that the risk of this kind of dispute disrupting supplies is reduced in the future" by saying that "the most important instrument could be Energy Charter and Transit Protocol... I expect, – said Mr. Piebalgs, – that during G-8 Presidency, that will be presided by Russia, these issues will be brought on the agenda by Russia and by other G-8 countries because it is very important to establish a clear and transparent mechanism to avoid any disruption of supplies."

There is a growing consensus within the international community that bilateral disputes need to be solved through multilateral negotiations and the ECT and its instruments provide such a basis. The Energy Charter Protocol on Transit can enable greater transit capacity and secure established transit flows. The Russian-Ukrainian gas dispute demonstrated the urgent need to finalise the Transit Protocol, pending results of bilateral consultations between Russia and the EU on three outstanding issues. In its December 2005 annual meeting the Energy Charter Conference decided that both contracting parties should present the schedule of its finalisation before end-February 2006. In mid-January Henning Christophersen, the Conference Chairman, has approached both Russia and the EU requesting that this instrument be finalised in 2006. Two expert meetings have taken place since then (in March and April), two others are scheduled for May.

Today the ECT is the best available multilateral legally binding instrument uniting 51 member states of Eurasia, including all EU and FSU states. The ECT depoliticises and establishes commonly accepted minimum standards for energy trade, transportation/transit and investment between member states with effective dispute resolution mechanisms. Five countries have not yet ratified the Treaty, though two of those five (Russia and

Belarus) applies ECT on a provisional basis. These events might have created another stimulus for Russia to ratify the Treaty, especially considering the heightened attention brought to the challenges of energy security not only by the recent Russian-Ukrainian gas dispute, but by the very fact that Russia itself has put the issue of international energy security as central to its G-8 presidency this year.<sup>2</sup>

### Away from barter

Moving from barter or quasi-barter deals, toward contractual separation of transit and gas supply arrangements, with prices guided rationally by market principles, will go a long way in supporting transit reliability.

Barter or quasi-barter deals, as we know from the past, are always political deals. The USSR supplied energy to its political allies at discounts, as a hidden form of political subsidy. For example, oil supplied to Cuba (below world oil market price) was repaid with overpriced Cuban sugarcane. Oil supplies to COMECON countries were based on the escalation formulas (three to five-previous-years-average sliding scale), which in the 1970s lowered the price of the oil the USSR was supplying to Eastern Europe to around 60% of the world market price. Further subsidies (to balance mutual trade) were provided by the overpriced export of manufacturing goods from COMECON states to the USSR.

Politically motivated underpricing can transform into overpricing as well. This happened with USSR oil supplies to COMECON in the mid-1980s when, after the world oil price began falling in 1981 and then collapsed in 1986, the formerly below-market subsidized oil prices, due to the escalation formula effect, began to exceed world oil prices. And, finally, political pricing is not isolated to relations within the FSU and COMECON states. In the early 1980s Gas de France paid a 15% premium on LNG imported from Algeria, as the "hidden" form of France's political aid to Algeria.

Usually, when 'special' political relations come to an end, barter deals dissolve and the contracting parties move to the 'arms-length' commercial transactions of the marketplace. Gas supplies based on commercial prices and agreements have always been secure, and disputes are usually subject to arbitration. Gas supplies

<sup>2</sup> A. Konoplyanik. Energy Charter: the key to international energy security. – *"Petroleum Economist"*, February 2006, p. 19-20.

based on political pricing will suffer from changes in the political relationship and corresponding agreements will usually be murky. No effective dispute settlement by a third party is available within political pricing schemes. Considering these points, the barter arrangement between Russia and Ukraine before January 4<sup>th</sup>, 2006, was a political deal reflecting political prices for both gas supplies and transit fees. Accordingly, the switch to more market-oriented prices was clearly a politically-motivated but market-oriented change. Thus we must now examine the issue of market-based pricing.

### Natural gas: pricing and prices

No global gas market exists today, neither for pipeline gas (technical reasons), nor for LNG (an undeveloped market). There is no world market price for gas, no universal world gas pricing mechanisms, unlike the world oil market. There are a few regional gas markets and they are at different stages of market development (mature, intensive growth, initial phase of growth). The availability of a diversified gas infrastructure gives multiple choices to suppliers and consumers, and serves as an objective precondition for moving to a competitive gas market structure. The ratio of the length of gas distribution networks to that of trunk gas pipelines may serve as a metric of the market's development. According to IEA data, the ratio is 6:1 for Western (up to 10:1 in Netherlands and almost 14:1 in the UK) and Central Europe and 3:1 in CIS, including (according to other analysts) 2:1 in Russia. That indicates that the CIS and Russia are at an earlier stage of the gas market's development – with all the attendant consequences, including those related to pricing and prices.

Within regional markets, local market forces corresponding to the particular stages of energy markets development in that region will of course yield different gas prices. Gas-pricing mechanisms evolve as energy markets develop from initial to mature stages: from supply-based cost-plus (in the initial stages), then to demand-based escalation formulas (e.g. replacement values of gas substitutes), and finally to futures-based pricing leading to gas-to-gas competition, in a mature gas market.

Thus, there is no unified market price within Eurasia because gas prices within the segmented markets of Europe, Ukraine, Russia, Turkmenistan, and prices in the cross-border flows between them, are set by different market principles. Market forces would act through different pricing mecha-

nisms (methodologies) and would lead to different market prices (values/levels) at these markets.

Within more mature markets, with a diversified energy mix and diversified competitive supplies, gas can be substituted by other energies. In those markets gas prices are determined by the replacement value of competing energy products. Mature economies with high saturation of gas grids, reflecting sunk investments and usually with higher income levels, allow for higher gas price. Economies at the earlier stages of energy market development, with lower levels of infrastructure saturation and usually with lower income levels, cannot support higher gas prices. They just can't afford this environmentally- and user-friendly high-class energy. So for any producer there is a clear economic preference to sell its gas to mature economies ("hot" markets) at economically justified higher prices, rather than to economies in transition ("cool" markets) at also economically justified, but lower prices. If both options are available and suppliers decide to sell to the "cool" markets, it would be a political decision for a political price.

It is the sovereign decision of the countries who own these resources, how to develop and use their resources – including how to price them. For domestic use, compensation (beyond cost recovery) for the depletion of a finite resource may not be deemed necessary, as the cost of this finite resource is transferred directly to the benefit of the national economy.

When energy resources are exported, a country will usually maximize the compensation for the resource depletion, within the limits of its marketability, i.e. the value to the customer. For gas, that is the price of competing gas or the price of substitutes (mainly fuel oils). Apart from possible commercial considerations (e.g. speeding up sales), exporting gas for a price below its value could only be motivated by political considerations. Evidently such prices will become subject to political relations. A cost-plus price would include a usually fixed (and limited) depletion compensation. If the resulting price is above the value to the consumer, the gas cannot be marketed, and in the opposite case a certain benefit from the ownership of the resources is transferred to the purchasing country. Only a net-back pricing approach, based on the net-back of the replacement value to the customer/importer, ensures marketability and is free from politically motivated price benefits, and thus stable against changes in political relations between exporter and importer.

**Political vs. non-political pricing**

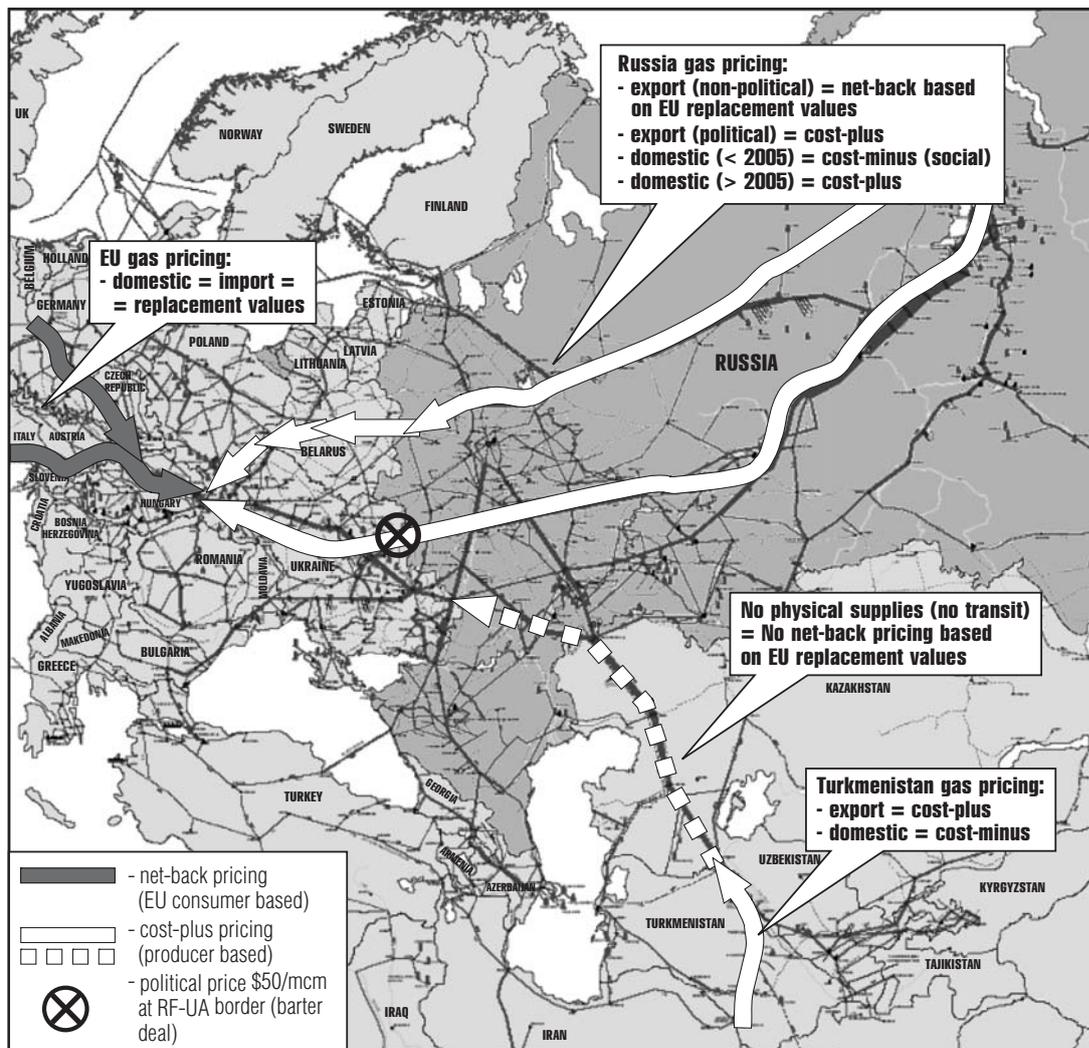
In the case of EU-bound Russian gas exports via Ukraine, 'political' (i.e. subsidized) export pricing means introducing the producer state's domestic market pricing ('economic' cost-plus or even 'social' cost-minus, e.g. until 2005 Russian Gazprom sold gas at a loss domestically) to export pricing, instead of economically justified 'non-political' net-back pricing based on gas replacement values within internal EU market net-backed to external border of exporter (points of reference: EU-on-border prices at delivery points for Russian gas to EU).

Russia's gas exports to 'non-political' (non-subsidized) pricing zones have been steadily expanding. Prior to 1991 it covered only EU-15; after 1991 – EU-15 plus former COMECON plus FSU Baltic states; since 2004 – EU-25, etc. After Janu-

ary 4th, 2006, it would cover EU-25 plus Ukraine (to some extent – see below) plus other FSU/CIS states (except Belarus, which is a member of a Union State with Russia). So prior to January 4th, 2006, the 'meeting point' of demand-based and supply-based pricing for Russian gas exports, ie. of 'political' and 'non-political' pricing, was located at, or west of Ukraine's western border (see map 1). By the January 4th agreement it was moved to the eastern Ukrainian (e.g. to Russian-Ukrainian) border (see map 2).

Gas prices in mature markets are dependent on oil price development. Oil prices (reflecting gas replacement value) are going higher (as in 2005), and demand-based gas prices are going higher as well, though with some time-lag. The increasing gap (between demand-based and supply-based gas prices) makes the transition from

Map. 1. Evolution of Russian Gas Export's "Political" and "Non-Political" Pricing Zones (pre – 2006, January 4)

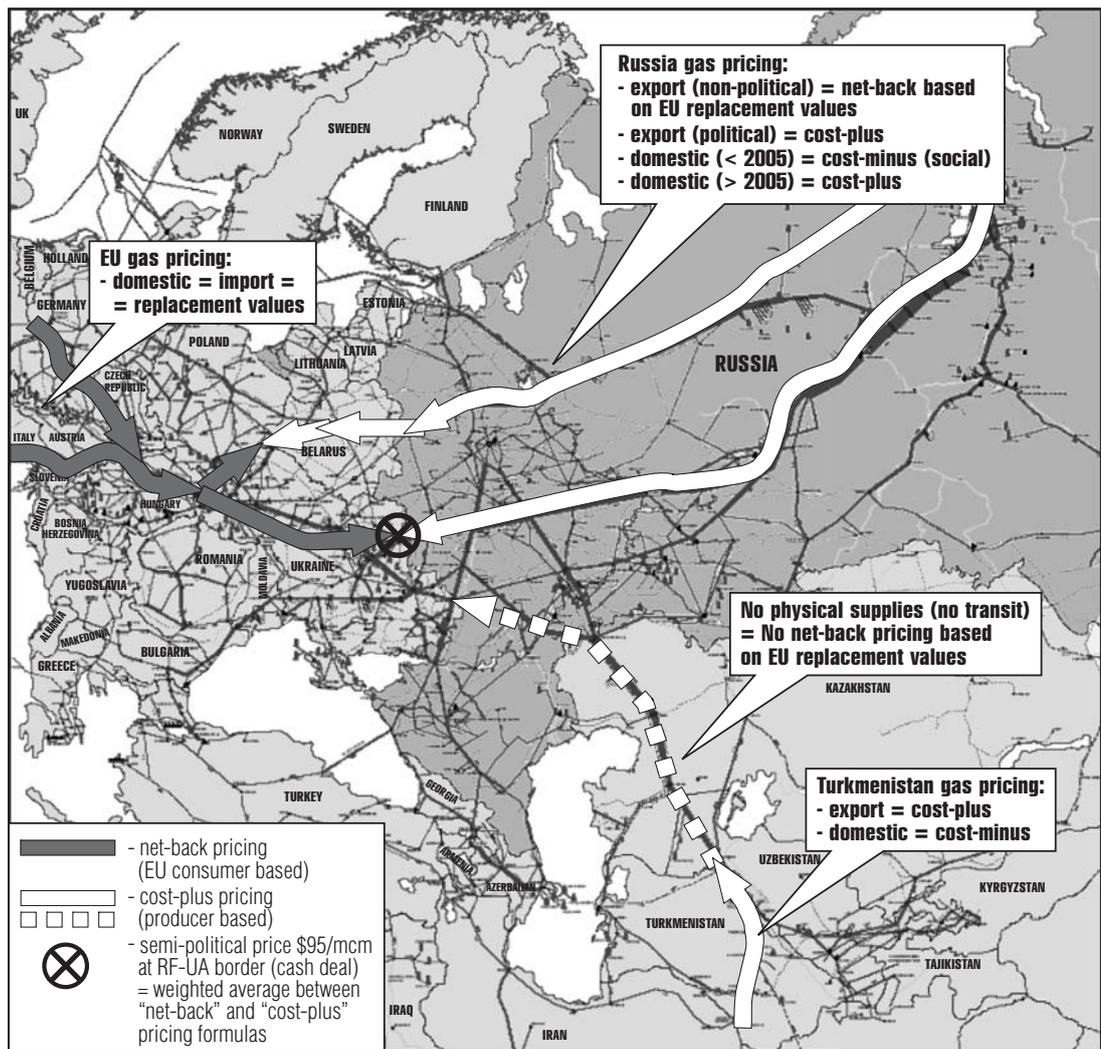


Map source: CGES

the cost-plus price to the replacement value price level politically and economically more (and perhaps insuperably) difficult. The fact that in less than ten days of intense and sometimes acrimonious negotiations, both parties – Russia and Ukraine – came to an agreement, must be considered a positive step forward. A compromise solution was nearly impossible, when at the same geographical point Russia would like to receive ‘European’ prices based on the EU gas replacement value net-backed to the Russian-Ukrainian border, and Ukraine was not ready (neither politically nor economically) to pay this price. For a compromise to be reached, a third party needed to be included in the deal. Thus has RosUkrEnerg added to the gas mix the flows of Central Asian gas, purchased at the corresponding producers’ borders at much lower cost-plus fob prices (see diagram 1).

One could say that the deal will likely not be stable in the long-term, that it lacks transparency and many details remain unclear. That’s mostly true; many concerns still exist. Greater transparency is needed for both gas supply and transit. While contractual issues between companies are subject to normal considerations of confidentiality, governments could reveal more information on inter-governmental energy agreements to ensure a legal framework for transit issues – both of which measures would help us to foresee potential problems. The more transparent the situation is, the easier it is to avoid the conflicts. Such a deal would represent the first step away from political- and towards market-based pricing, hopefully to be accompanied by further steps towards the creation of open, competitive energy markets within the ECT area. □

Map. 2. Evolution of Russian Gas Export’s “Political” and “Non-Political” Pricing Zones (post – 2006, January 4)



Map source: CGES