



## The new Ukrainian-Russian gas deal

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**The gas dispute between the Ukraine and Russia left Europe without a supply of Russian gas for more than 20 days in January - the largest energy conflict since the Arab oil embargo of the West in 1970.**

The origins of the dispute between the two countries date back to the break up of the USSR in 1991 when Russia found itself dependant on Ukraine for the transportation of most of its gas to Europe and Ukraine, its economy heavily dependant on subsidised prices for gas. It also found itself unable to pay the market price for gas which Russia demanded of the now independent Ukraine.

After the 1994 Orange Revolution, Ukraine sought to develop closer ties with the EU, NATO and the US - much to Russia's disapproval. At the same time Ukraine remained unable to pay market price for its gas.

Over the years, tension increased and on three occasions "Gas Transit Wars" broke out: in January 2006, March 2008 and July 2008. However, these previous wars did not disrupt the supply of gas to Europe.

The latest disruption - in January 2009 - was not unexpected. Naftogaz (the Ukrainian state gas company) owed Gazprom for 2008 gas supplies and there was no agreement on 2009 prices. Since the two countries had found themselves in similar situations before, nobody expected such a long stand-off.

Gazprom estimates its direct losses as a result of the standoff at US\$2 billion while the Russian government losses in uncollected export duties total more than US\$700 million.

Not taking into account the loss to its industry which is heavily dependant on gas or its loss in transit fees, the cost to Ukraine has been estimated at more than €100 million.

In addition, the economies of Greece, Hungary, Macedonia, Moldova, Montenegro, Serbia, Croatia, Bulgaria, Slovakia and Romania suffered as a result of supplies of gas being completely cut off for weeks.

Of these countries, Bulgaria suffered the most as it depends on Russia for almost all of its gas. Losses of its industrial capacity in Bulgaria is estimated at €300 million. Some 160,000 households in Sofia and other cities in Bulgaria were left with no heating as temperatures plummeted to below -10 degrees C.

Until Ukraine starts paying the market price for gas, the possibility of further disruption remains. However, there is hope that the agreement will hold.

For the first time, the price of gas is to be calculated using a European market-based formula. The agreed average price to be paid by Ukraine in 2009 will be below US\$250/1,000cm, given the falling price of crude oil and oil products, and was set at a 20 per cent discount on the price paid by European customers. Similarly, Russia will pay a discounted transit fee in 2009.

From 2010 both parties will pay market prices calculated pursuant to a price formula linked to crude oil prices.

The transit and supply agreements have been decoupled and each concluded for a period of 10 years.

The decoupling of the two agreements is an important concession by the Ukraine which has, in the past, used transit as a bargaining chip when disputes arose regarding its failure to pay for gas supplies on time. It is also seen as providing additional guarantees that the disruption in supplies to European customers will not be repeated.

An important provision of the agreement reached is the apparent elimination of RosUkrEnerg, a Swiss-registered intermediary which to date controlled the Russian-Ukraine gas trade.

For many it is the squabbles over the apportionment of profits between Gazprom and the Ukrainian oligarchs as shareholders of RosUkrEnerg that are the real reason behind the past gas wars.

Removing the intermediary would increase transparency and reduce the opportunity for corruption.

However, since announcements to this effect have been made in the past, it is too early to say whether this time it will actually happen. There is no doubt that the success of the agreement depends on how the issue of RosUkrEnerg is resolved.

The key to the success of the deal reached on 20 January 2009 depends on the ability of Ukraine to pay the higher gas prices.

The Economist Intelligence Unit assesses of the state of Ukraine's economy as bleak. With its industry heavily dependant on steel, fertiliser and chemical exports, Ukraine has been hit had by the global slump in the commodity prices.

According to official statistics, the country's industrial output fell by 37 per cent in January (year-on-year) while unofficial figures suggest that output contracted by more than 20 per cent in January alone.

With the Ukrainian currency losing a third of its value since autumn, Ukraine is teetering on the verge of bankruptcy.

The Ukrainian Prime Minister has been trying to borrow wherever she can.

In November 2008, the IMF approved a US\$16.43 billion emergency loan to the Ukraine - the first tranche of which (US\$4.5bn) Ukraine received earlier this year.

With the approval of the second tranche not yet approved, secret meetings were held with Russia on 7 February for US\$5 billion to cover Ukraine's budget deficit.

With the European Union offering little in concrete support for the Ukrainians, uncertain times lie ahead for the country.

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