

Natural Gas

Bakers Research Note

The Russian-Ukrainian Gas Dispute:

The End or Just the Latest Chapter?

By Thomas Paul

Introduction

In recent years, Russia has become one of Europe's largest energy sources, largely through the supply of natural gas, which is used for electricity-production, heating and in industry. This natural gas is supplied to Europe through a vast network of gas pipelines which run out of Russia from the Baltic Sea in the north to the Caspian Sea in the south, spreading out across first Eastern then Western Europe. This network is critical to both Russia and Europe to ensure that the natural gas can be supplied quickly and efficiently from the supplier to the market. Due to the geographical layout of Europe though, many nations in Eastern Europe especially are not only clients of Russian gas, but are also required to permit gas to transit through their territory to other client nations.

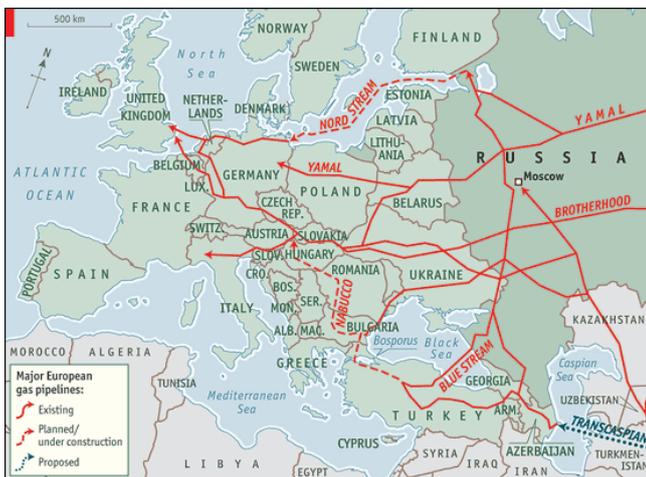


Figure 1. Natural Gas Pipelines from Russia

Disputes between these transit nations and Russia can have serious consequences for other European nations downstream, as was seen in the recent dispute between Russia and Ukraine. This dispute, which started as dispute over what Ukraine should

pay for its own gas imports, soon escalated when Russia first refused to supply Ukraine with gas for domestic gas, and then closed the supply off entirely, suspecting that Ukraine was siphoning off gas destined for Europe to meet its own needs.

This dispute has only just been resolved with European countries reporting gas flows returning to normal, after two cold weeks of difficult and often-tense negotiations between the three parties. This event though is important for investors to understand for neither is it an isolated incident, nor is it likely that all the issues and motivations have been fully resolved. The consequences of this dispute will be felt by Russia, Ukraine and Europe for some time.

The Falling Out of Brothers

The core of this dispute is over the pricing of the natural gas that Russia sells to Ukraine for domestic consumption and the pricing of the transit costs which Ukraine charges to use its gas pipeline network. To say that this is the only issue in this dispute is a simplification though. In many ways this dispute is just part of the continuing saga of the break-up of the Soviet Union, of which Russia and Ukraine were once two of most powerful parts. Since the dissolution of the USSR and the independence of Ukraine in 1991, Russia and Ukraine have had a complicated and sometimes tense relationship dealing with many Soviet-era legacy issues and Ukraine's moves into the European sphere.

The break-up of the Soviet Union and the introduction of new economic methods caused many changes throughout the former USSR and Eastern Bloc. As new nations formed and old ones reaffirmed their independence, dividing up what had in effect once been a single nation, proved difficult. Where there had once been one Ministry of the Oil and Gas Industry of the USSR, now each nation had an often-partly-privatised entity to operate and maintain the gas infrastructure and business, such as majority-state-owned Gazprom in Russia. Where there had once

Natural Gas

Bakers Research Note

been a tightly controlled pricing model employed, now market forces could be permitted to be used.

Before the current dispute arose, Russia through Gazprom, had been selling Ukraine gas for domestic use at rates far below the market price in Europe. This was a “brotherly” act on behalf of Russia to its former Soviet ally. Prices had been under \$200 per 1000 cubic metres when European nations had been paying around \$500 per 1000 cubic metres.

In the last few years though, relations between Ukraine and Russia have been becoming more and more strained. This is partly due to the Orange Revolution in Ukraine and Ukraine’s increasing desire to move more into the European Community. Russia to some extent perceived this as an attempt to reduce Russia’s importance to the Ukraine. Ukraine is not the only country which Russia is concerned about leaving its sphere of influence, with Georgia and other neighbouring nations expressing interest in the European Community.

Russia in response to this perceived betrayal has been pressuring Ukraine and other nations through various means. One way in which this was done was by demanding that these nations pay market rates for the gas like the European nations do. This has naturally been resisted by Ukraine due to the potentially devastating effect on the economy due to such a large price increase on such a critical input. This has only widened the political gulf growing between the two self-described former brothers.

Europe: Caught in the Crossfire

While both Russia and Ukraine do have legitimate concerns and goals in this dispute which need to be addressed, it is their methods of dispute resolution that has caused the most concern. Ultimately, the party that has been most effected by this dispute has been the European Community, most notably Eastern Europe and the Balkans. As can be seen in Table 1, these nations are the ones with the highest

dependence on Russian gas imports, whilst at the same time being those that lost the most supply. Compounding the problems for those countries in the southern regions like the Balkans is the distance and smaller volume of the alternative supply pipelines which flow through Belarus, Poland and Turkey.

Table 1. Countries Affected by the Supply Stoppage

Directly Effected Nations	Portion of Domestic Supply Sourced from Russia ^{1,2}	Loss of supply via Ukraine from January 7 th
Slovakia	100%	100%
Bosnia	100%	100%
Macedonia	100%	100%
Moldova	100%	100%
Bulgaria	96%	100%
Serbia	87%	100%
Greece	82%	100%
Czech Rep.	80%	75%
Turkey	67%	100%
Slovenia	64%	100%
Austria	60%	90%
Hungary	60%	100%
Poland	47%	90%
Germany	42%	100%
Croatia	37%	100%
Italy	28%	90%
Romania	28%	100%
France	24%	70%

The dispute came at a bad time for Europe as well. Given that gas is often the main source of heating, having a gas supply shortfall during winter can cause serious problems, but this dispute came just as Europe entered a cold snap which dropped

¹ The Ukrainian pipelines are not the only source of Russian gas for the majority of these countries, though in most cases the Ukrainian pipelines are the major source.

² “Factbox: Countries affected by Russia-Ukraine gas row”, *Reuters*, January 10th 2009

Natural Gas

Bakers Research Note

temperatures in some regions to 10 degrees Celsius below the average. While it would be mistaken to believe that this dispute was taken more seriously by European leaders due to the colder temperatures, it certainly made the crisis more acute to the general population.

Now that supply has resumed, Europe has some serious questions to be asking. These questions largely surround the twin questions of could this dispute between Russia and Ukraine flare again; and how can Europe be protected from the fallout.

During the dispute, numerous agreements were made and repudiated by both Russia and Ukraine, while blaming the other for the latest set back. This lack of good-faith by the two parties infuriated European leaders. European Commission President and former Portuguese Prime Minister, José Manuel Barroso, was so exasperated by the negotiations that he openly criticized Russia and Ukraine for refusing to implement various agreements which had only just been agreed to and revealed he had threatened legal action against both parties should the final agreement fall through³. This clearly shows that Europe has little faith that this latest agreement will last for long, let alone its supposed 10-year life.

It would be incorrect to say that Europe has not seen disputes between Russia and the transit countries coming. In recent years, European nations and companies have been moving to find ways to directly access Russian gas as well as reducing their reliance on the supply. Recently France announced the construction of new nuclear reactors and Germany is leading the world in renewable energy usage. These are just two examples of how Europe is moving to securing their energy requirements through domestic production.

³ "Gas flows as Russia-Ukraine gas dispute thaws", *The Times*, January 20th 2009

Russia is also aware of this growing move by Europe away from its gas. In response to this, it has been pushing for new pipelines to be built, through other transit nations such as Turkey, or avoiding transit nations entirely by building links through international waters such as the Baltic Sea. Russia is promoting these new and improved pipelines as a better and quicker alternative which elevates Europe's energy security concerns while keeping Europe as a client.

Conclusion

For the time being, the dispute seems to have been settled with Russia and Ukraine. They have agreed to a European-rate linked price for Ukrainian domestic consumption, though one which is still significantly below the market rate, and similar price increase in the transfer fees paid by Russia for the use of the Ukrainian pipelines. This agreement was agreed to be valid for the next ten years, though there already doubts as to the length of its life given the European Commission President's comments.

Europe is faced with the dilemma in this regard. They have the choice of trusting that this dispute will remain resolved and no further supply stoppages are coming. This would not seem to be reasonable to rely on though, with gas pricing disputes between Russia and transit nations like Ukraine and Belarus, becoming all but a regular event. The other option for Europe is to move to secure their energy supplies, or in other terms move away from dependence on Russian gas. European leaders seem clearly more in favour of this move logically, and the shift to alternative energy has already begun.

In either event, there are clear potential benefits and dangers for investors need to take consideration of throughout the European energy sector.

For any inquires regarding this Research Note, please contact the author:

Thomas Paul: tpaul@bakersgroup.com.au

Natural Gas

Bakers Research Note

Disclaimer

This Research Note has been prepared for the use of Bakers Investment Group (Australia) Pty. Ltd. ("Bakers") clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Bakers.

The information used in this report was obtained from various sources and we do not guarantee its accuracy. Bakers makes no representations or warranties whatsoever as to the data and information provided in any third party referenced source and shall have no liability or responsibility arising out of or in connection with any such referenced source.

This Research Note is for general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this Research Note. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investments or investment strategies discussed or recommended in this Research Note and should understand that statements regarding future prospects may not be realised. Investors should note that income from such securities or other investments, if any, may fluctuate and that the price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this Research Note.

Officers of Bakers or one or more of its affiliates may have a financial interest in the securities of the issuer(s) or in related investments.

Copyright © 2009 Bakers Investment Group (Australia) Pty. Ltd. All rights reserved