

Götz, Roland

Research Report

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After the Gas Conflict

Economic consequences for Russia, Ukraine, and Germany

Roland Götz

In January 2006, the conflict between Russia and Ukraine over future gas prices, which had escalated at the end of 2005, was settled for the time being with a compromise. While the Russian company Gazprom has benefitted from the agreement, the reputation of Russia as a reliable energy supplier has been damaged. The case raises some important questions: What strategy will Gazprom pursue in the post-Soviet area? Is Russia in a position to exert pressure on its European customers? What can the European Union, and in particular Germany, do to improve energy relations with Russia?

Although Russia's Gazprom switched off the gas supply to Ukraine on 1 January 2006, the latter managed to avert the five-fold increase in the clearing price which the Russians had originally announced. This was, among other things, due to the Ukrainian practice of taking gas from the Western European gas networks. According to the agreement of 4 January 2006, Ukraine still pays a lower price for natural gas from Gazprom than the rest of the CIS states—with the exception of Belarus which, in turn, had to hand over its export pipelines to Gazprom (see table 1).

The agreement, which is in force until 2010, is profitable first and foremost for Russia's Gazprom and the intermediate trading company *RosUkrEnergo*. So far, Gazprom delivered gas in kind to Ukraine as a compensation for using Ukrainian pipelines for the transportation of its gas

Table 1
Prices for Gazprom gas supplies
(US\$/1000 m³)

To	2005	2006
Germany	200	
Slovakia, Slovenia	180	
Western Europe, average	174	250
Poland	120	
Turkey	75	
Estonia, Latvia, Lithuania	85–95	120–125
Moldova	80	160
Georgia	68	110
Azerbaijan	60	110
Armenia	56	110
Ukraine	50	95
Belarus	47	47
Russia	38	46

Source: Bofit Weekly, (2006) 1, <www.bofit.fi/bofit/eng/3weekly/index.stm>; <www.gazpromquestions.ru/news/news8.htm>.

exports. This gas would have earned some \$4 billion on the European gas market in 2005. In 2006 and the years following, Gazprom will have to pay only about \$2 billion for the transit (see table 2).

Table 2
Ukrainian gas bill in 2005 and 2006

2005	Amount (bn m ³)	Cost (\$bn)
Gas from Turkmenistan at \$44 per 1000 m ³	28	1.2
Gas from Gazprom in kind for transit*	23	
Total gas imports	51	1.2
2006		
Gas from Central Asia at \$95 per 1000 m ³	40	3.8
Gas from Gazprom at \$95 per 1000 m ³	11	1.0
Total gas imports	51	4.8
Transit charge**		-1.8
Net payment	51	3.0

* Transit of 120 bn m³ over 1088 km at a charge of \$1.09 for 1000 m³ over 100 km, reduced by \$250 mln for the repayment of old debts, converted into gas at \$50 per 1000 m³.

** Gazprom has to pay Ukraine a transit fee of \$1.6 per 1000 m³, while the other conditions remain the same as in 2005.

As Ukraine now has to pay RosUkrEnergo a standard price of \$95 per 1000 m³ of Central Asian and Russian gas, Ukrainian payments for gas will rise from \$1.2 billion in 2005 to almost \$5 billion in 2006. Taking into account the transit fee, which Gazprom receives from Ukraine, Kiev's payments will amount to some \$3 billion per annum.

This increase of import costs by about \$2 billion (with a GNP of about \$60 billion) will cause considerable problems for the Ukrainian economy. However, it could escape these problems by selling its export pipelines to Gazprom, using the proceeds to either subsidise the domestic gas prices or to modernise outdated power plants.

However, this option is not being considered—at least not for the time being.

Gazprom's strategy in the CIS area and the consequences

In the conflict with Ukraine, the basic economic and political problems of the post-Soviet gas and energy market became evident once again:

1. Thus far Gazprom has been supplying the CIS states through different and—compared with the prices charged on the European market—rather favourable special conditions. However, now it wants to quit the old Soviet practice of subsidising its neighbouring countries. This policy will ruin the outdated and energy-intensive heavy industries of these countries to a great extent while Russian industrial gas consumers continue to enjoy the protection of government-fixed low prices. To be sure, an increase of the gas price may also stimulate higher efficiency of energy consumption and thus could lead to a modernisation of production and local suppliers but this would take many years and require considerable investments. Therefore, it is more likely that the CIS countries will increasingly switch to the use of cheaper but ecologically questionable burning of coal and heavy oil or switch to nuclear power.

2. As a monopolist not only of the Russian gas market but also of the gas pipelines running from Central Asia through Russian territory, Gazprom is in a position to keep independent Russian gas producers as well as the Central Asian suppliers (Azerbaijan, Kazakhstan, Uzbekistan, Turkmenistan) out of the direct export business. Thus, competition on the CIS gas market is largely prevented.

3. The Russian state uses Gazprom as an instrument for its industrial and social policy by regulating the domestic gas price. Low prices for natural gas lead to an extended use of gas as an industrial fuel as well as for the generation of electricity. While on the one hand this is favourable

from an ecological point of view, on the other hand, due to a lack of need for modernisation, it results in the waste of energy. Gazprom has to sell two-thirds of its gas production (about 300 billion m³) on the domestic market at a loss, which curbs its investment power. As a consequence, the opening up of the huge gas deposits in Northern Russia will be delayed.

Diversification as an instrument of energy security

The quick end to the recent Russian–Ukrainian conflict over gas price might be best explained by the determination of the Russian leadership to settle it as fast as possible. After all, Russia wants to present itself during its G-8 chairmanship as a respectable energy supplier of world-wide importance. While the gas affair has caused harm to the Kremlin’s image, in fact, Gazprom gives no reason to doubt its reliability as a supplier. The very fact that gas supplies to Ukraine were quickly resumed made it evident that turning off the gas tap is not a real option for Russia. The Russian side can neither force its will on transit countries nor on European customers because it is fundamentally dependent on both of them.

The hope that “exclusive” pipelines such as the “Blue stream”—which goes through the Black Sea to the North coast of Turkey or the planned Baltic pipeline—will provide more options by evading the transit countries is illusory. This is due to the fact that the decline of dependency on the transit countries will only be replaced by an increased mutual dependency of suppliers and buyers.

A high volume dependency on Russian natural gas is characteristic in particular for the CIS countries and the Eastern EU member states (see table 3), whereas the dependency of Western Europe is relatively low. Nevertheless, the Europeans would be well-advised to further diversify their energy supplies geographically.

Table 3
Imports of natural gas from Russia in 2004

	<i>Imports from Russia (bn m³)</i>	<i>Percentage of total Imports (%)</i>
Moldova	2.7	100
Serbia	2.3	100
Estonia	0.9	100
Bulgaria	3.1	100
Finland	4.3	100
Latvia	1.5	94
Lithuania	2.9	94
Azerbaijan	4.9	89
Hungary	9.3	85
Greece	2.2	80
Slovakia	5.8	80
Austria	6.0	77
Romania	4.1	70
Czech Rep.	6.8	69
Poland	6.3	69
Turkey	14.5	65
Belarus*	10.2	52
Ukraine*	34.3	50
Germany	37.3	41
Italy	21.6	35
France	13.3	30

* Additionally substantial imports from Central Asia.

Source: Aleksey Krashkov, “Rossiya perekraivaet ekonomicheskuyu kartu mira” [Russia reshapes the economic world map], in: *Nezavisimaya gazeta*, 16.12.2005.

In order to achieve this goal, there are plans to build a number of new pipelines from Northern Africa as well as the “Nabucco” pipeline from the eastern border of Turkey to Southern Europe and to use liquid gas technology. This will be an outright revolution in gas supply, which will make the gas market a world market—as happened before with the oil market. In the course of this process, European gas imports from Russia will continue to rise in absolute figures but there will be a decrease in the relative share. At the same time, the share of gas from Africa, the Middle East, and the Caspian region will increase considerably.

Table 4
Percentage of total European gas imports*

From	2000	2020
Africa	30	38
Middle East/Caspian region/ others	1	22
Russia	69	40

* Refers to all European states west of the former USSR.

Calculation on the basis of figures in: Observatoire Méditerranéen de l'Energie (OME), *Analysis of Future Supply Sources and Costs for Europe*, June 2004, <www.ome.org/PDF/Lettres/newsletter24.pdf>.

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SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3-4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

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Conclusion: Prospects for the Eastern energy market

Gazprom's strategy is to confine competition on the post-Soviet gas market and to act as the sole supplier of Russian natural gas. This is also why Gazprom is trying to regain the export pipelines which, after the collapse of the Soviet Union, became the property of the successor states. This strategy—which from a business point of view is absolutely rational—is supported by the Kremlin, which views Gazprom as an instrument of its economic and social policy and as a cornerstone of its energy policy. Moreover, the Kremlin is considering the creation of a "Gas-OPEC" which would control the European gas market under Russian leadership. However, it is doubtful whether this strategy is in the well-conceived interest of Russia as it would create an intransparent company which would be exposed to competition on international markets. Furthermore, it would not really be responsible either to its shareholders or to the control organs of the state due to its status as a partly private and partly state-owned company.

The strategy of Gazprom is principally incompatible with the European idea of competition and non-discrimination in the field of energy policy. In order to exert influence on the energy economy in Russia and its neighbouring countries, the EU, for its own interest, should focus its policy more on the following aims:

- ▶ In its energy dialogue with Russia, the EU should emphasise the aspect that the best way to gain good results for the national economy is competition. Therefore, Europe should call for a step-by-step abolishment of state-control of domestic Russian gas prices.
- ▶ The EU should not surrender to Russia's refusal to ratify the Energy Charter and should not accept discrimination of both domestic producers, and foreign suppliers and investors in Russia. The ratification of the Energy Charter by Russia should be prioritised even more so in the energy dialogue between the EU and Russia.
- ▶ Finally, there is the particular question for Germany as to how it should proceed with the gas transport consortium, which Russia and Ukraine agreed upon in 2002 and which Germany joined. The treaty in which the three countries committed themselves to cooperation in the overhaul and extension of the existing pipeline net and in Ukrainian gas export, should be opened for other interested states. This consortium could help in avoiding future conflicts about gas transit through Ukraine.