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Kyiv's gas strategy: closer cooperation with Gazprom or a genuine diversification

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In recent months Kyiv has been intensifying its efforts to diversify Ukraine's gas supply routes with a view to reducing the country's dependence on imports from Russia. One of the steps which Kyiv has taken has been to make the unprecedented decision to start importing gas from its Western neighbours. In November 2012, Ukraine's state-owned Naftogaz began importing gas through Poland under a two-month contract with RWE (the imports continued into 2013 under a separate deal), while in the spring of 2013 Ukraine started importing gas from Hungary. Kyiv is also currently looking into the possibility of purchasing gas from Slovakia. Furthermore, since 2010 the Ukrainian government has been working on the construction of an LNG terminal near Odesa. The authorities have declared that this will allow Ukraine to import up to 5 billion m^3 of LNG a year by 2015. The government has also taken measures to increase domestic production, including from non-traditional sources, and it plans to replace gas-based with coal-based technologies in local power stations. Finally, in January 2013, the government signed a 50-year production sharing agreement with Shell. This paves the way for the development of Ukraine's shale gas deposits.

Most of these initiatives are part of the official national energy strategy, which aims to increase domestic production and significantly reduce Ukraine's dependence on gas imports by 2030[1]. However, Kyiv's current gas offensive stems mainly from the country's failed efforts to revise the unfavourable gas contract signed by Yulia Tymoshenko's government in 2009. Due to Ukraine's disproportionately heavy reliance on natural gas and, consequently, the over-dependence of the country's economy on the increasingly unaffordable gas imports, the current government sees a revision of the 'Tymoshenko contract' as one of its main objectives. How Ukraine deals with the current economic recession and whether President Yanukovych will be re-elected in 2015 are believed to be dependent on whether this goal is achieved. Moscow, however, has set tough conditions for any changes to the current contract: in exchange for revising the terms of the deal, Russia wants complete control over Ukraine's gas pipelines and/or for Ukraine to take an active role in the re-integration process of the post-Soviet states. As a result, Ukraine's diversification projects, coupled with a significant reduction in gas imports, have had a negative effect on Gazprom's performance, and have increased Kyiv's bargaining power in its negotiations with Moscow. This however also means that if Moscow were to agree to a revision of the gas deal, Ukraine may need to abandon its current gas diversification projects, and possibly even its entire energy policy.

[1] Under Ukraine's Energy Strategy to 2030, adopted in 2006 and now partly obsolete, the share of imported gas in the annual consumption is to drop to 19% by 2030. The amendments to the Energy Strategy, passed on 7 June 2012, put the figure at under 11%.

The importance of gas for Ukraine's economy

Natural gas is Ukraine's main energy source, accounting for about 40 per cent of the country's primary energy supply. Ukraine has significant (traditional) **gas reserves**, estimated at 5.4 billion m^3 (including 1.1 billion m^3 of documented reserves)[2]. Domestic **production**, after peaking 40 years ago (at 68.1 billion m^3 in 1975) has been gradually falling and has stabilised in recent years at around 20 billion m^3. **Consumption levels** have fallen from 118 billion m^3 in 1991 to less than 55 billion m^3 in 2012 (see Appendix, Figure 1). Nonetheless, Ukraine remains a major gas consumer, ranking thirteenth in the world and fifth in Europe[3].

Heavy industry is the largest consumer of natural gas in Ukraine (accounting for 40% of domestic consumption) followed by households (over 30%). About 20% of gas is used by communal heating systems supplying both government buildings and residential properties, and it is estimated that as much as 9% of gas is wasted, for example through heat loss during transmission[4]. Gas also plays an important social function in Ukraine: providing cheap fuel to the general public is seen by the government as a way to ensure relative social stability in the country. Consequently, all gas, with the exception of that purchased by industry, is subsidised by the state. 90% of gas produced domestically is controlled by the state and is sold to individual and government consumers at fixed prices. This is reflected in the poor financial performance of the state-owned gas producer Naftogaz. The company supplies gas to local consumers at a loss[5] and has for years depended on state subsidies to stay afloat. At the end of 2012 Naftogaz and its subsidiaries owed $7.7 billion to local banks - an enormous sum by Ukrainian standards[6].

Despite a drop in gas consumption from 118 billion m^3 in 1991 to 55 billion m^3 in 2012, Ukraine remains a major gas consumer: ranking 13th in the world and 5th in Europe.

In the past two decades, gas imports from Russia and the ex-Soviet republics of Central Asia made up over 70% of Ukraine's demand for gas. Despite a drop in import volumes from 53 to 33 billion m^3 between 2008 and 2012 (see Figure 2), a rapid increase in the price of gas has caused a huge upsurge in the annual cost of gas imports: from less than $4 billion in 2005 to $14 billion in 2011-2012. Gas is Ukraine's biggest import at present and is the main cause of the country's structural trade deficit.

[2] Ukraine 2012. Energy Policies Beyond IEA Countries, p.82. The data refer to conventional gas. According to preliminary assessments, Ukraine also has large unconventional gas resources: from porous sandstone (2-8 billion m^3), shale gas (5-8 billion m^3), coalbed methane (12-25 billion m^3). See also Mykhailo Honchar, First steps into the unknown. The prospects of unconventional gas extraction in Ukraine, OSW Commentary, No. 106, 27/04/2013; http://www.osw.waw.pl/en/publikacje/osw-commentary/2013-04-27/first-steps-unknown-prospects-unconventional-gas-extraction-ukr

[3] After Russia, the UK, Italy and Germany (2011); until 1994, Ukraine was the world's third largest gas consumer (after Russia and the US). See: U.S. Energy Information Administration (http://www.eia.gov).

[4] Source: Ukraine's Energy Strategy for the period until 2030 (the Government's amendments to the strategy of 2012), pp. 63-64; mpe.kmu.gov.ua/fuel/doccatalog/document?ild=222032

[5] The price of gas for households consuming up to 2,500 m^3 a year (which accounts for the majority of end users) is equivalent to $91-$100 per 1,000 m^3 (depending on the presence of gas meters), i.e. less than 25% of the cost of gas imported by Naftogaz from Russia.

[6] http://www.epravda.com.ua/publications/2013/01/14/356088/. In the first quarter of 2013, the debt increased by about $1 billion, although it is not clear whether Naftogaz paid off some of its previous debt during this period. In 2012, Naftogaz reported a net loss equivalent to $1.3 billion; in the first quarter of this year losses increased by 87% on the same period last year, reaching $ 970 million. http://www.unian.net/news/570913-naftogaz-v-i-kvartale-uvelichil-chistyiy-ubyitok-pochti-v-2-raza.html

Ukraine remains the main **transit route** for Russian gas sold to Europe, which earns Kyiv over $3 billion a year in transit fees ($2.97 billion in 2012[7]), making it the country's most lucrative export service recently. However, following Russia's launch of the Nord Stream pipeline, which bypasses Ukraine, gas transit volumes have been steadily decreasing. In 2004 more than 120 billion m³ of Russian gas was transported through Ukraine; this figure dropped to just 84 billion m³ in 2012[8].

Viktor Yanukovych's ambiguous attempts at reform

Despite official declarations to reform the Ukrainian gas sector and to diversify the country's supply routes, consecutive governments have done little to implement real change. For years Kyiv's policies have tended to be rather reactive, focusing on minimising the negative effects of the changing conditions of the supply of gas from Russia and Central Asia. The policies have tried to take advantage of Russia's dependence on Ukraine as a transit country and have blocked Moscow's attempts to seize control of Ukraine's gas pipelines[9] and sought support from the West in gas disputes with Russia. Following Ukraine's Orange Revolution in 2004, Russia began to steadily raise the price of gas supplied to Ukraine, with a view to eventually bringing it in line with the rates paid by other European states (until 2005 Kyiv was charged as little as $50 per 1,000 m³; since then the price has risen steeply to reach $426 per 1,000 m³ in 2012 - see Figure 3). Over the course of a series of 'gas wars', Moscow has introduced increasingly harsh terms and conditions for any new deals with Kyiv. The last 'gas war' ended on **19 January 2009** with the signing of a gas supply **contract** which is to remain in force until the end of 2019. The new pricing formula agreed in the deal is based on the market price of petroleum products and sets a very high base rate ($450 per 1,000 m³ of gas). It also sets the minimum annual purchase at 52 billion m³, introduces a 'take or pay' clause on 80% of that amount[10] and bans Kyiv from exporting any of the gas it purchases from Russia. Moscow's decision to temporarily suspend gas supplies to several European countries during the most recent gas conflict drew international attention to the issue and prompted the EU to offer Kyiv help in modernising the country's gas network, with the proviso that Ukraine reforms its gas sector. The condition was partly met by the new administration led by Viktor Yanukovych, who won the presidential election held in February 2010.

Ukraine's past governments failed to reform the country's gas sector. The current attempts to address the issue are motivated by Ukraine's poor economic performance.

In July 2010, Ukraine passed an energy bill which brings the local gas market closer in line with EU standards, including the introduction of a clear separation of legal entities involved in the extraction, transportation and the sale of gas. This was followed by Ukraine's accession to the Energy Community in 2011. As a result,

[7] http://economics.unian.net/rus/news/168069-naftogaz-v-1-m-kvartale-sokratil-dohod-ot-tranzita-gaza-na-18.html

[8] http://www.unian.net/news/556667-ukraina-sokratila-tranzit-rossiyskogo-gaza-v-es.html

[9] In 2007, amendments to the bill on pipeline transport prohibited any changes of ownership in state-owned companies in the sector.

[10] In 2009, import volumes were set at 40 billion m³. The 'take or pay' clause covered 80% of the annual shipment volume, i.e. 41.6 billion m³ (52 billion m³ minus 20%). The contract allows for adjustments of +/- 20% of the contracted amount, thus reducing Ukraine's minimum obligatory imports to 33.3 billion m³ [80% x (52 billion m³ - 20%)] - as long as the reduction is agreed by both parties no later than six months before the start of a calendar year. See: http://www.pravda.com.ua/articles/2009/01/22/3686613/

Ukraine is expected to implement a number of EU directives concerning the operation of the country's gas and electricity sectors, leading to a greater liberalisation and a gradual integration between the Ukrainian and the European energy markets. It should be noted however that Ukraine has undertaken these reforms mainly out of necessity due to the country's poor economic performance and the need for foreign aid. An IMF loan, for example, was offered on the condition that Ukraine agree to a gradual rise in gas tariffs for individual consumers and for local power plants to provide residential heating and hot water (for 50% at the first stage). However, when the country's financial situation stabilised, Kyiv began to put off further price hikes it had agreed on with the IMF and in 2011 the remaining loan disbursements were frozen. As the country approached the 2012 parliamentary elections, the economy slowed down, support levels for the ruling Party of Regions dropped, and the reformist zeal began to decline. This was reflected in the slow pace of reform[11] and the increasingly unclear direction of Kyiv's policies. The privatisation of local gas distribution companies and the partial liberalisation of gas imports mainly benefited the companies owned by Dmytro Firtash, a controversial businessman with close links to the president.

Kyiv continues to see its cooperation with the West as a way of improving its bargaining position in its relations with Russia. This is because since the beginning of Yanukovych's term of office, the main objective of the new government and of the oligarchs linked to the cabinet (who also control the country's largest industrial gas consumers) has been to secure a revision of the 2009 contract. The **Kharkiv Agreement** signed in April 2010 has put a cap on the scale of the price hikes[12] but the main unfavourable terms of the 2009 gas contract (the pricing formula calculated from a very high base price and the 'take or pay' clause) remain in place. Kyiv's repeated attempts to amend the terms of the deal have so far failed to produce any tangible results. In fact, Russia's position on the matter consolidated further when the EU and Ukraine reached the final stages in their negotiations on an Association Agreement in 2011. The symptoms of a weakening economy and the rapidly rising cost of Russian gas have prompted Kyiv to change its tactics. In January 2012, President Yanukovych set his government a course of action based around three key steps designed to weaken Ukraine's gas dependence on Moscow: first, domestic gas production should increase; second, there should be a shift from gas-based to coal-based technologies in the country's power plants; and third, gas imports should be diversified.

In 2012 Kyiv intensified its cooperation with Western energy companies interested in the exploration and development of local gas deposits, including non-traditional deposits.

Projects aimed at increasing domestic production

Last year, Kyiv intensified its **cooperation with Western companies in the exploration of Ukraine's** prospective **gas deposits**, including deposits of non-traditional gas. In the spring of 2012 the government chose the oil company Shell to be an investor and the state's partner in developing the Yuzivska field (eastern Ukraine).

[11] The government waited until June 2012 to establish UkrTransGaz (responsible for the transportation of gas) and Ukrgazvydobuvannya (major domestic producer of natural gas) as separate legal entities.

[12] In exchange for agreeing to extend the lease for the Black Sea Fleet in Crimea, Russia offered Ukraine a discount of up to \$100 per 1,000m³ of gas.

Chevron was successful in a similar bid for the development of the Olesska deposits (western Ukraine), while in the summer of last year a consortium dominated by ExxonMobil and Shell was awarded a contract for the Skifska deposits in the Black Sea. On 24 January 2013, the Ukrainian government and Shell signed a 50-year production sharing agreement for the Yuzivska field. According to some commentators, the Ukrainian partners in the above-mentioned projects - Nadra Yuzivska and Nadra Oleska, both of which were established by the state-owned Nadra Ukrayny (90% stake) and a small, specialised private company SPK-Geo-Servis (10% stake) - are likely to be influenced by individuals closely linked to the president[13]. Given the nature of the local business environment, such influence could increase the project's chances of success. Nonetheless, these initiatives will not see a positive outcome immediately: if geological tests confirm the presence of the deposits, production on an industrial scale would not start for another 5-6 years. According to the redrafted Energy Strategy, by 2030 about half of Ukraine's production is to come from non-traditional gas deposits (including 6-11 billion m^3 of shale gas a year)[14].

Some of Ukraine's recent gas initiatives give the impression that they have been designed to benefit mainly individuals with close links to the current president.

Last year, state-owned Chornomornaftogaz (a Naftogaz subsidiary) intensified its efforts to raise gas production levels on the Black Sea shelf between 2011-2015 from 1 to 3 billion m^3 (in 2012 local production reached 1.2 billion m^3 and is predicted to rise to 1.65 billion m^3 in 2013). These efforts have also led to operations being commenced at the Odesa offshore field and, upon completion of an 83 kilometre long underwater pipeline, locally produced gas will be pumped into the national gas network.

A planned conversion from gas to coal--based technologies

On 25 December 2012, Naftogaz and the **China Development Bank** signed a $3.7 billion loan agreement. Under the deal, Kyiv will use the money to finance Ukraine's gradual **switch from gas-based to coal gasification technologies** developed by China. The deal followed an agreement being signed on 13 July 2012 for cooperation on the implementation of the project between Ukraine's Ministry of the Energy and Coal Industry and the CDB. The agreement was also preceded by an amendment to Ukraine's state budget, passed on 30 July 2012, which increased the maximum size of state guarantees for the proposed loan by UAH 29.5 billion (approx. $3.7 billion). The funds are to be made available for a three-year period. The government's programme and the Chinese loan have, however, led to a number of questions being raised. Under the scheme, Ukraine is to start using water-coal slurry fuel (consisting of fine coal particles suspended in water), with combustion characteristics similar to those of fuel oil and "synthesis gas" - a fuel mixture consisting mainly of methane and carbon dioxide (produced through the gasification of coal or lignite). Official estimates suggest that the projects financed under the agreement would allow Ukraine to replace up to 4 billion m^3 of imported gas (which until now has been in use as fuel in thermal power plants) with locally extracted coal. As a result, the Ukrainian government would be able to guarantee sales of up to 10 million tonnes of local coal annually and could produce savings of $1.5 billion due to a reduc-

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[13] See http://www.epravda.com.ua/publications/2012/08/7/331514/ and Mykhailo Honchar, First steps into the unknown... op.cit.

[14] Mykhailo Honchar, First steps into the unknown... op.cit.

tion in gas imports[15]. Ukrainian experts, however, have raised doubts about the forecasted economic effects of this scheme and about the real intentions of the government in Kyiv. So far there are no reliable estimates of the actual cost of producing such fuel from coal. (Unlike in China, where cheaper opencast lignite mining is used in the production process, in Ukraine the production would need to be based on deep-lying coal deposits). The financial plans submitted by Naftogaz show that only one of the projects scheduled for implementation in 2013 involves a switch from gas to coal, while the other three focus on the construction of coal gasification plants near the consumers of their future energy output. In official documents, Naftogaz defines these consumers as "chemical and fertiliser plants". The decision to locate the proposed energy plants close to chemical plants controlled by Dmytro Firtash suggests that the project may mainly be of benefit to him or to an interest group associated with the Ukrainian president's son, Oleksandr Yanukovych, which controls some of Ukraine's coal industry, and which is locally known as 'the family'[16]. To date, however, no significant progress has been made in the implementation of the conversion programme. On 10 June 2013, acting on the president's instructions, Ukraine's Energy Ministry established an interdepartmental working group led by Deputy Minister for the Energy and Coal Industry Ihor Popovych. The group has been tasked with the coordination of the programme, including the negotiation of contracts for the implementation of the individual projects.

Kyiv's diversification offensive

Ukraine's plans for the diversification of its gas supply routes were first put forward in 2010. Under the so-called National Projects initiative, the government proposed the construction of an LNG terminal with an initial capacity of 5 billion m^3. From the start, though, the project has been seen as little more than a bargaining chip in Kyiv's gas negotiations with Moscow. It has met a series of setbacks, which have caused delays and raised questions about the feasibility of completing the project in line with the original proposals. The problems include: limited interest from potential investors (the state was initially expected to be only a minority shareholder), the low credibility the project itself has (marred by a scandal during the signing ceremony for an agreement on the creation of a consortium of investors[17]), a lack of clear information about gas suppliers (official reports suggest Egypt, Algeria, Nigeria, Qatar, Turkmenistan and Azerbaijan). There have also been changes to the actual design of the terminal. The original proposals envisaged a land-based structure which would be ready for use in 2014. Under the new plans however, phase 1 of the project would see the construction of a terminal on a floating platform provided by Excelerate Energy which would be fully operational by 2015. This would be followed by a land-based terminal scheduled for completion by the end of phase 2 in 2018. The new design would also increase the annual capacity of the entire complex to 10 billion m^3. In addition to the design changes, progress on the project has also been stalled by Turkey's continued reluctance

Ukraine's most spectacular and quantifiable diversification project involves gas imports from across the country's western border, accompanied by a significant drop in gas imports from Russia.

[15] http://www.kmu.gov.ua/control/uk/publish/article?art_id=245910468&cat_id=244276429

[16] http://www.epravda.com.ua/publications/2013/06/3/377845/

[17] The document was initialled by a person who did not have power of attorney to represent the company introduced by officials as Kyiv's key partner in the project.

to grant Kyiv permission to ship gas through the Bosphorus. Consequently, the plans to construct an LNG terminal in Ukraine appear to be the least realistic of all Kyiv's projects aimed at reducing the country's dependence on gas imports from Russia.

Meanwhile, the most spectacular and quantifiable diversification initiative which Kyiv has undertaken has been the **decision to begin importing gas from across the country's western border**, and at the same time to radically reduce gas imports from Russia. In May of last year, Naftogaz and RWE Supply & Trading signed a one-year framework agreement for the import of up to 5 billion m^3 of gas to Ukraine. On the basis of this agreement, the companies signed a short-term contract for the

The recent developments do not necessarily determine the future direction of Ukraine's energy policy. A potential agreement to revise the 2009 gas contract with Russia could raise questions about the viability of many of the diversification initiatives.

supply of 53 million m^3 to Ukraine in November and December 2013 via a pipeline across Poland. The cooperation was extended into 2013, with transfer volumes reaching network capacity in the second quarter of 2013 (over 4 million m^3 per day, potentially allowing annual imports of up to 1.5 billion m^3 along this route alone). In April, Ukraine began gas imports from Hungary. The volumes imported were initially low (totalling only 18.1 million m^3 by the end of May) but they increased significantly in June, reaching 138 million m^3. According to figures released by Ukraine's gas network operator UkrTransGaz, between November 2012 and the end of June 2013, Ukraine imported 683 million m^3 [18] of gas from the two countries, including 527 million m^3 via Poland. The gas purchased from RWE is up to 10% cheaper than the gas supplied by Gazprom under the 'Tymoshenko contract'. Kyiv is pointing to this fact in order to emphasise the unfairness of both the pricing formula set by Russia and of the terms of Kyiv's current contract with Gazprom.

Last year, Ukraine imported only 33 billion m^3 of Russian gas (a drop of nearly 27% against 2011), of which Naftogaz purchased just 25 billion m^3 (8 billion m^3 was bought by Ostchem, owned by Dmytro Firtash). This, together with the continuation of the so-called "virtual reverse flow" of Russian gas from Europe back to Ukraine (a phrase coined in Moscow to describe Kyiv's gas imports from Europe), has caused a strong reaction from Russia. On 23 January 2013 Gazprom issued Naftogaz with a bill for $7 billion for 16 billion m^3 which Kyiv had arguably failed to purchase (calculated as the difference between the minimum quantity of gas set out in the 'take of pay' clause of the Tymoshenko contract and the amount of gas actually collected and paid for by Naftogaz). Kyiv rejected the bill, claiming that it had informed Gazprom about Kyiv's plans to reduce imports from Russia. However, under the terms of the current contract, any such change needs to be approved by both parties at least six months before the beginning of the year in which shipments are to be reduced. In addition, on 29 April 2013, the government in Kyiv approved its forecasted gas balance for 2013, according to which Ukraine intends to reduce gas imports to 27.3 billion m^3, of which only 18 billion m^3 will be purchased under the contract between Naftogaz and Gazprom (8 billion m^3 is to be imported by Ostchem, and 1.3 billion m^3 is to come from Kyiv's contract with RWE). The government has also announced the possibility of further reductions in 2014.

[18] http://www.utg.ua/uk/press/site-updates/україна-в-червні-майже-вдвічі-збільши/

More strategic decisions yet to come

Despite Ukraine's initiatives aimed at diversifying its gas supply routes, Kyiv is continuing its efforts to negotiate a new gas contract with Moscow. In February of this year, President Yanukovych said that Kyiv might allow Russia to jointly manage the Ukrainian gas transmission network in exchange for a reduction in gas prices and guarantees that Ukraine would continue to be used as a transit country. On April 26, the government submitted a bill in parliament demanding legal guarantees for Russia's access to Ukraine's pipelines[19]. So far, however, the bill has not received approval in the Verkhovna Rada and on 28 June Gazprom's CEO Alexei Miller stressed that, under the circumstances, any negotiations on establishing a gas consortium would be pointless. Gazprom had warned Kyiv that it was considering the construction of a new gas pipeline which would bypass Ukraine and, according to reports in the Ukrainian press, Gazprom blocked Kyiv's attempts to test the viability of gas imports from Slovakia[20]. The success of the tests could have paved the way for a real alternative to gas imports from Russia (the capacity of the pipeline linking Slovakia and Ukraine is several times higher than that linking Ukraine to Poland and Hungary). Despite the disagreements, on 26 June Gazprom agreed to a $1 billion loan for Naftogaz in the form of a prepayment of transit fees (covering Moscow's financial obligations towards Ukraine until the end of 2014). So far Gazprom has also decided not to take legal action against Kyiv over its refusal to pay the $7 billion bill for unclaimed gas. These gestures of goodwill might suggest that an agreement between the two parties is still possible. At the same time however, despite earlier talks about a gas consortium, many serious differences of opinion remain, with neither side willing to make significant concessions. Particularly strong objections have been voiced in Ukraine in response to Moscow's demand that the prospective consortium be granted exclusive use of the Ukrainian gas transmission network, effectively forcing Kyiv to leave the Energy Community. On 21 March 2013, this suggestion was repeated in front of the European media by Russia's Prime Minister Dmitry Medvedev[21]. Besides running contrary to Kyiv's international obligations, such calls are also in conflict with the vested interests of the Ukrainian oligarchs (including those with links to Oleksandr Yanukovych), who want to be able to export gas from domestic deposits (including from shale gas deposits) and who are determined to maintain their access to the Ukrainian transmission network. Agreeing to Moscow's demands would also prevent a real diversification of gas supply routes into Ukraine. Finally, the dispute also concerns the future of Ukraine's gas storage. Moscow needs this to facilitate its gas exports to Europe. Kyiv will therefore need to decide whether access to Ukraine's gas storage should be granted exclusively to Russia or whether it can turn the facilities into an energy hub for Central Europe.

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[19] The project allows, for example, transition system operations to be privatised

[20] In an interview with the weekly *Dzerkalo Tyzhnia* (21 June 2013), representatives of the German supplier of gas to Ukraine, RWE, said that the transmission of gas through Slovakia could not begin because the 2009 contract between Naftogaz and Gazprom provides that Gazprom is the de facto operator of the main section of the Ukrainian gas pipeline used to deliver Russian gas to Slovakia. This allows Gazprom to block attempts by Slovakia to re-export Russian gas, http://gazeta.zn.ua/energy_market/ukraina-dlya-rwe-ne-babochka-podenka-a-perspektivnyy-torgovyy-partner-_.html. If Gazprom is in fact entitled to exercise its right as the operator for the main section of the pipeline under the 2009 contract (which remains unclear), it seems unlikely that the company will allow the deal to go ahead before the current contract runs out at the end of 2019.

[21] http://www.unian.net/news/560622-rossiya-uje-shantajiruet-ukrainu-truboy-medvedev-ozvuchil-uslovie-alyansa.html

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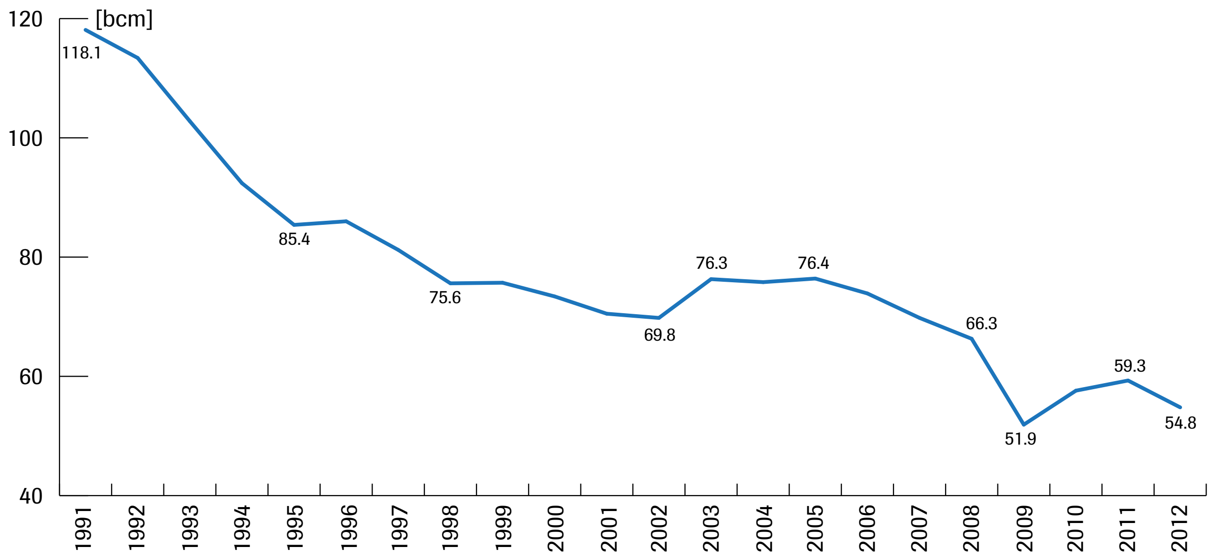
The gas policies recently pursued by the Ukrainian government are in stark contrast to the rather passive approach adopted by previous cabinets. The policies form a part of a coherent reform of the Ukrainian gas sector undertaken jointly by Kyiv and the EU under the Energy Community Treaty. The recent developments in this area, however, do not necessarily determine the future direction of Kyiv's energy policy and are easily reversible. The individual changes to the gas sector, including its partial liberalisation, have led mainly to Naftogaz becoming increasingly marginalised and to the rise of old players (Ostchem) and new players (VETEK - considered to represent the interests of the "family"). They have also created a legal basis which will allow Russia to gain at least partial control of Ukraine's transit pipelines.

Kyiv hoped that the diversification of import routes and a significant reduction in the volume of gas purchased from Russia would win it concessions from Moscow, which in turn would allow both sides to reach a compromise. A new gas agreement with Russia, however, could result in the rapid closure of the majority of the gas projects initiated by Yanukovych. As a consequence of a series of practical problems dogging the projects (such as the lack of progress on the LNG terminal or short-term contracts for the import of raw materials from Europe), the recent initiatives seem to be little more than elements of a bargaining game played by the Ukrainian government. In reality, what is at stake here is not so much a new gas deal with Russia, insomuch as the ability of the current president to secure re-election. Ukraine's geopolitical position in the region appears to be of lesser importance.

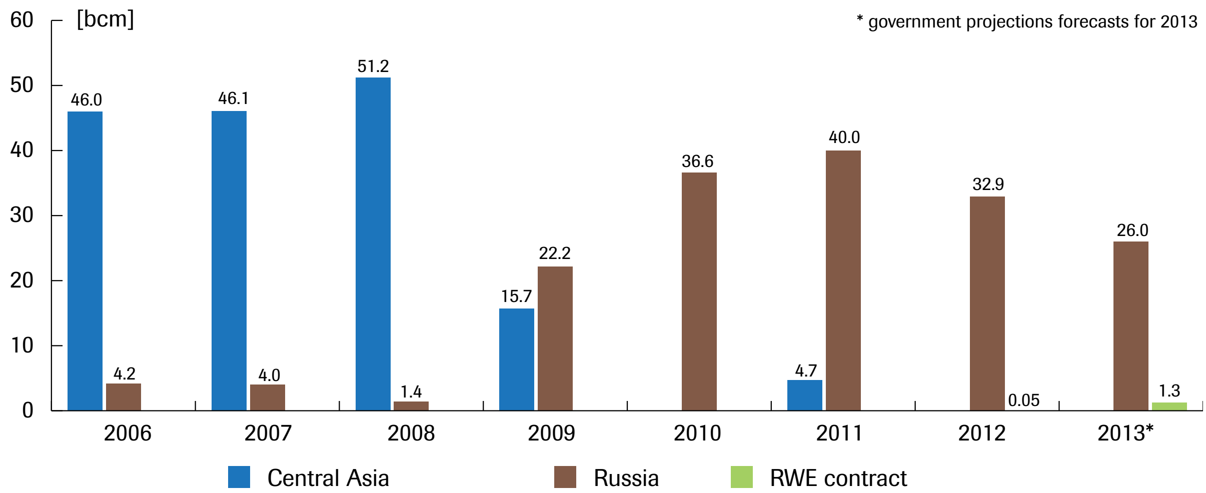
APPENDIX

Ukraine's gas consumption between 1991-2012 (bcm)



Source: Ministry of the Energy and Coal Industry of Ukraine, IEA, Razumkov Centre.

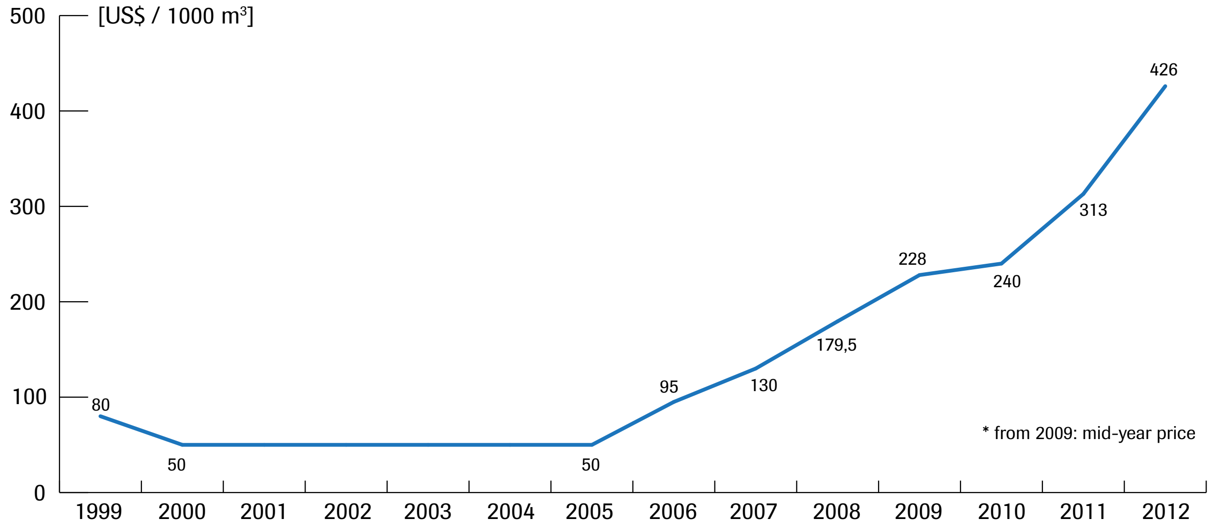
Volume and origin of gas imports to Ukraine between 2006-2013 (bcm)



Sources: Ukraine's Energy Strategy to 2030. Ministry of the Energy and Coal Industry of Ukraine (2012)

* The statistical dominance of Central Asian states in the breakdown of gas imports to Ukraine between 2006-2008 is a consequence of the mechanism in place in the local gas market following the first Russia-Ukrainian 'gas war' (2005-2006). At the time RosUkrEnergo (RUE) became Ukraine's sole gas importer, offering local consumers relatively low prices. Although the gas was officially imported from Central Asia, in reality its exact origin remains unknown because RUE freely mixed these supplies with more expensive Russian gas.

Changes in the price of gas imported by Ukraine (US$/1,000m^3)



Source: Ukraine's Office for National Statistics, Ministry of Energy and Coal Industry of Ukraine, Razumkov Centre

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