<u>The Russia-Ukraine question</u>
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I have been asked to speak about the Russia-Ukraine relationship in the natural gas sphere. I will deal with (1) the background – Russia adapting to new market conditions in Europe, (2) the reverse flow trade and its effect on Ukrainian imports, and (3) some questions about the future.

1. Background: Russia is adapting to new market conditions in Europe

Since the 2008-09 economic crisis the European gas market has changed fundamentally, and Gazprom has had to adapt to these changes. First, gas prices on the European hubs fell sharply in 2009, and a wide differential opened up between these prices and the oil-linked prices in Gazprom's long-term contracts. Consequently (i) the proportion of Europe's gas that was sold at hub prices increased steadily, and (ii) Gazprom was forced – by negotiations and in many cases by arbitration – to make concessions to its customers on price levels and price formation.

In the present situation, with low gas prices in Europe, all the gas that Gazprom sells in Europe above the minimum Take-or-Pay levels potentially needs to compete with gas from elsewhere. Gazprom simultaneously found its political and regulatory problems in Europe piling up. It has had to take decisions about price versus volume.

Gazprom appears to be becoming more flexible in its marketing policy. It has agreed to discounts and other changes of contract terms; it has experimented with sales of spot gas (e.g. the auctions of 3 bcm of gas at St Petersburg); it has indicated readiness to go further in providing customers with flexibility. We expect that it may continue to keep options open, continue to be prepared to sell more gas at lower prices in order to defend (at least) its market share.

Over the long term (e.g. to 2030) demand for Russian gas in Europe is very likely to rise, since even if demand remains sluggish and competition from other fuels increases, the decline in indigenous European production will leave a large gap that can realistically only be filled by Russian imports or liquefied natural gas.

These changes in Gazprom's European export business have had two consequences for Ukraine. 1. Gazprom has effectively shifted to a flexible policy of pricing the gas it sells to Ukraine against "reverse flow" gas. 2. Having initially stated that it would not transit gas across Ukraine after 2019, Gazprom has changed its position, and is ready to negotiate on post-2019 transit, in order not to undermine its market position.

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2. Reverse flow has not replaced Russian imports, but it has created price competition

Reverse flow has not replaced Russian imports, but has produced price competition

Gas imports into Ukraine: prices and volumes		From Russia		From Europe	
		Avg price, $/mcm	Volume, bcm	*Avg price, $/mcm*	Volume, bcm
2014	Q1	*$268.5*	6.09	*n/a*	0
	Q2	*$485*	7.84	*$282*	0.6
	Q3	*n/a*	0	*$352*	1.63
	Q4	*$378*	0.52	*$353*	2.84
2015	Q1	*$329*	2.16	*$304*	3.65
	Q2	*$247*	1.54 (est)	*$280*	2.65 (est)
	Q3	*$247*	0	*$270-280*	2.5 (est)
	Q4	*$227.36*		*$230-235*	
2016	Q1	*Not agreed*			

Sources: news reports, companies, author's estimates

In Q4 2014 and Q1 2015, reverse flow gas was cheaper. With the $100 discount extended, Russian gas was cheaper in Q2 2015. For Q4, Gazprom offered a price slightly lower than reverse flow

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It may well be that the price competition that has been established between reverse-flow deliveries and direct imports from Russia will be the way that prices are set for some time into the future. This price competition is not working perfectly, and political factors influence prices … but it is working.

After February 2014, Ukraine made reducing dependence on Russian imports a political priority and sought to expand reverse flow. This policy bore fruit in Q4 2014 and Q1 2015, when about 6.5 bcm was imported via reverse flow, at prices that were $30-40/mcm lower than the Russian gas available under the first trilateral EC-Russia-Ukraine agreement.

In Q2 and Q3 2015, Russia changed its policy and made gas available at prices $30-40/mcm lower than the price of reverse flow gas. Ukraine nevertheless bought little Russian gas in Q2 and none in Q3, presumably in order to minimise dependence on Russia, but not as the cheapest option.

For Q4, Russia again offered gas at a price a few dollars lower than reverse flow prices. With the conclusion of the "winter package" agreement, under which Ukraine will buy Russian gas at $227.36/mcm, this policy has resulted in a restart of direct imports. Our interpretation is that, notwithstanding all the political factors at work, prices are being set by means of competition between suppliers.

Furthermore, whatever happens this winter, the post-Soviet pricing system based on the type of long-term contracts between Gazprom and Naftogaz, covering the sort of volumes they did in the past, is finished. An important part of the reason is the substantial fall in Ukrainian consumption over the long term – down from around 70 bcm/year in the mid

2000s to 42 bcm in 2014 and 34 bcm (estimated) in 2015 – that will never be fully reversed.

3. Some questions for the future

After the cancellation of South Stream, will Russia really go ahead with its transit diversification plans?

One line of Turkish Stream is likely to be built. The steel has been ordered, and it is commercially logical, since the western part of Turkey is likely to be a growing market for Russian gas. Politically, it seems that Gazprom and at least some of its European counterparties would be interested in continuing with further strings of Turkish Stream, or with Nord Stream expansion, or both. While these pipelines will certainly not be completed by 2020, it is possible that during the 2020s Russia will have put in place sufficient pipeline capacity to reduce Ukraine transit to a minimum, or to zero.

This leads to my next question …

What is the point of Ukraine's transit business?

Given the political and economic conditions, is it logical to prioritise the development of the transit business? (I am not speaking about the storage capacity.) The disputes over transit have been, and will probably remain, highly political. So why not see it as a business in decline, and concentrate on other activities?

Naftogaz Ukrainy has stated that it wishes to move the sales point for Russian gas to European customers to the eastern border. But neither Gazprom nor its European customers are likely to favour such an idea. Their contracts, some of which run to 2030 or 2035, provide for sale of gas on Ukraine's western border.

European companies are reluctant to take on Ukrainian transit risk. Their attitude is sharply at odds with that of European politicians – but it is the companies, not the politicians, who take the commercial decisions.

The gas storage capacity, as distinct from transit pipelines, is a different story

Some progress is being made in integrating Ukraine's market rules with those in Europe. Provided this continues, Ukrainian storage capacity could be offered to companies in central and eastern Europe. Of course this can not happen tomorrow, as the implementation of market reforms will take time.

And some questions about what happens after 2019

… that is, after the expiry of the current import and transit contracts between Gazprom and Naftogaz Ukrainy.

■ Will Russia continue to invest in transit diversification, to reduce transit via Ukraine to zero? (This probably depends on political factors, and on Gazprom's overall investment commitments.)

■ Will Ukraine move from emergency measures to a longer-term strategy of diversifying away from gas? Will such diversification, combined with higher domestic production, keep imports from Russia at low levels? (I think this is likely.)

■ Will Russia sell gas on Ukraine's eastern border to multiple buyers? (Probably only if it can be convinced that this would bring a commercially advantage.) Will Ukraine's market reform create a framework under which European companies will buy it there?

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