Breaking with the past

THE RESOLUTION of January's gas dispute between Russia and Ukraine signals a step away from political pricing towards market-based pricing. Hopefully, it will lead towards an open, competitive energy market across the region, as envisaged by the Energy Charter Treaty. By Andrei Konoplyanik, deputy secretary general, Energy Charter Secretariat.

Historically, Soviet energy supplies to political allies tended to be under-priced – a hidden form of political subsidy. That was the case here. January's agreement effectively ends a barter deal – under which Ukraine received Russian gas and Gazprom received access to Ukraine's Europe-bound pipelines – and replaces it with a contract agreement under which transit fees and gas supply are separated and set according to market principles (see small box).

This development is positive and was likely to happen anyway, as both countries had decided earlier to move away from barter to commercial terms. Adopting market terms can improve the reliability of transit. Gas supplies based on market prices and agreements are secure, and disputes are usually subject to arbitration. By contrast, gas supplies based on political agreements suffer from changes in political relationships, and there is no effective dispute-resolution mechanism in place.

Multilateral consequences

Reliability of transit is not just important to Russia and Ukraine. Although bilateral, the dispute had multilateral consequences – underlining the need for multilateral instruments for dealing with such disputes, such as the Energy Charter Treaty (see box p21).

The shift to a commercial footing has, in any case, been happening for some time. Before 1991, the non-political pricing zone for Russian gas exports covered only the EU15. Between 1991 and 2004, it expanded to the EU15 plus former Comecon (an economic organisation of communist states) countries and the Baltic states of the FSU. From 2004 until 4 January, it expanded to the EU25. Since 4 January, it has been extended west to encompass the EU25 and Ukraine. As part of a proposed union state with Russia, Belarus has not been included, however.

Natural gas: pricing and prices

Unlike oil, gas does not benefit from a unified world market. There is no world gas price and no universal pricing mechanism. The industry is fragmented into regional markets at different stages of development.

Many markets lack diversified gas infrastructure – a precondition for competition. The ratio of the length of gas distribution network to the length of trunk pipelines is one way of measuring the stage of a market's development. According to the IEA, this is 6:1 for western and central Europe and almost 14:1 in the highly developed UK. By contrast, it is just 3:1 in Commonwealth of Independent States (CIS) countries and, according to various estimates, 2:1 in Russia.

There is no unified market price in Eurasia because prices within the internal markets of Europe, Ukraine, Russia and Turkmenistan, and the prices of gas flows between them are defined by different market principles. As markets develop, pricing mechanisms evolve from a supply based cost-plus formula during the early stages to demand-based escalation formulae based on, for example, the replacement values of alternatives to gas. The next stage is futures-based pricing.

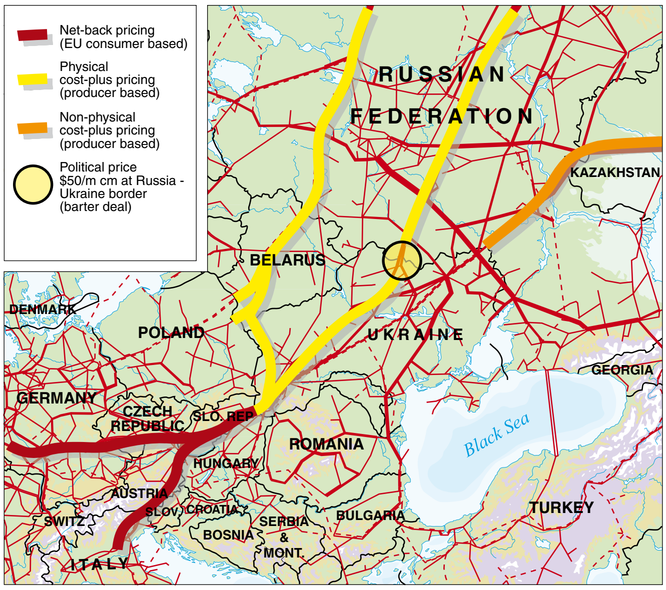
Mature economies with extensive gas networks allow for a higher gas price than economies at earlier stages of market development. Mature markets are, therefore, more attractive to producers than economies in

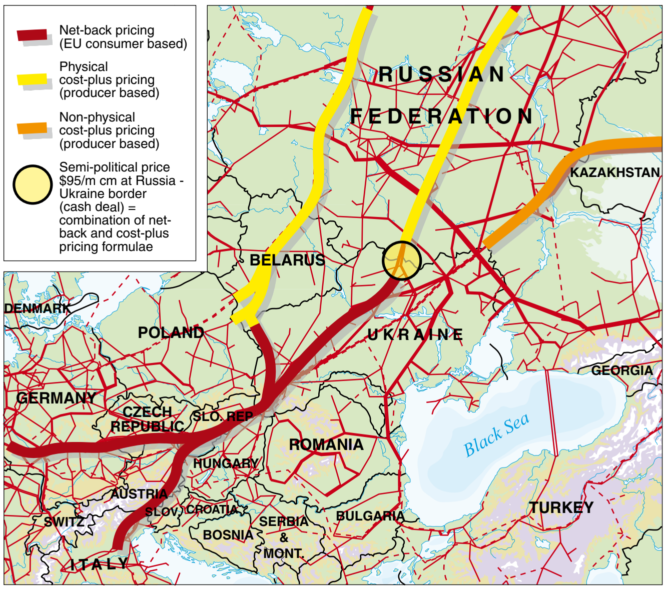
The devil's in the detail

BEFORE 4 January, Russia paid Ukraine a notional fee of $1.09/'000 cubic metres (cm) per 100 km to transit around 110bn-120bn cm/y of gas to Europe. This payment was made in kind, with gas supplied at a notional export price of $50/'000 cm. Additional volumes to cover the balance of Ukraine's demand were supplied at the same notional price.

Under the 4 January agreement, Russia will pay a transit fee of $1.6/'000 cm/100 km in cash. All gas supply to Ukraine from Russia will be supplied by RosUkrEnergo (RUE) – deliveries will include a mix of supply originating from Gazprom (sold to RUE for $230/'000 cm at the Russian-Ukrainian border) and cheaper supplies sold to RUE by Central Asian states. RUE's average price for gas supplied to Ukraine works out at $95/'000 cm for the first half of 2006.

Before the 4 January agreement, the meeting point of political, supply based pricing and non-political, demand-based pricing for Russian gas exports was on Ukraine's western border with Europe (see Map 1). Since the agreement, it has shifted to the Russian-Ukrainian border. □





Map 1: Evolution of political and non-political pricing zones for Russian gas exports, pre- (left) and post-4 January 2006

transition. Faced with a choice, a producer selling to transition markets has made a political decision to sell at a political price.

Political vs non-political pricing

That the agreement between Russia and Ukraine was reached in fewer than 10 days of negotiations is positive. Initially, a compromise looked almost impossible in view of the wide gap between the initial positions of both sides: Russia wanted a price based on the EU gas-replacement value net-backed to Russian-Ukrainian border, but Ukraine was not ready – politically or economically – to pay such a high price. Gas prices in mature economies reflect oil-price developments. Rising oil prices – as seen last year – result in rising demand-based gas prices, albeit with a time-lag. The increasing gap between demand-based and supply based prices makes the transition from a cost-plus to replacement-value price level politically and economically difficult.

However, the deal – which included a third party, RosUkrEnergo, as an intermediary to handle Central Asian gas – may not be stable in the long term. It lacks transparency and not every detail is clear. While contractual issues between companies are subject to confidentiality, governments can do more to release information on inter-governmental energy agreements and to ensure a legal framework for transit and transportation issues exists, which could highlight problems before they happen. The more transparent a situation, the easier it is to avoid conflict – another reason why the ECT has a critical role to play. □

The multilateral effect

JANUARY'S gas-price spat between Russia and Ukraine underlines the growing interdependence of producers, consumers and transit countries and demonstrates how bilateral disputes can quickly have multilateral implications. Indeed, there is growing recognition in the international community that bilateral disputes must be solved on a multilateral basis.

The Energy Charter Protocol on Transit can promote the creation of new transit capacity and secure established transit flows (*PE* 7/04 p34). The dispute underscores the urgent need to finalise the Transit Protocol, which is dependent on the results of bilateral consultations between Russia and the EU on three outstanding issues.

The importance of the Energy Charter process has been emphasised at the highest level. Following the Russia-Ukraine dispute, Andris Piebalgs, the EU energy commissioner, said the Energy Charter and Transit Protocol could be "the most important instrument" in reducing the chance of such a dispute disrupting supplies in the future. "It is very important to establish a clear and transparent mechanism to avoid disruption of supplies," he said.

The ECT is the best available multilateral, legally binding instrument. It depoliticises and establishes a commonly accepted minimum standard for energy trade, transportation/transit and investment between member-states, with effective dispute-resolution mechanisms. Of the 51 member-states – the countries of Eurasia, including the EU and the former Soviet Union (FSU) – five have not yet ratified the Treaty, but, of those, Russia and Belarus apply the ECT on a provisional basis. Recent events may encourage Russia to ratify the Treaty, however. Energy security, made topical by the gas dispute with Ukraine, is a central theme of Russia's G8 presidency (*PE* 2/06 p29).

Promisingly in this particular case, all implicated parties (Russia, Ukraine and the EU) considered the Energy Charter, both in its political and legal dimensions, as a basis for a settlement, although this was fortunately not necessary, as a compromise was reached. □