Gas and politics

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In 2005 Gazprom topped record 2004 performance in all operating categories, progressed major projects such as the North European Gas Pipeline and the Sktokman Field, completed the $13 billion purchase of oil company Sibneft, and saw its capitalization increase to $170 billion.

But the new year was to start controversially. On 1 January 2006 Gazprom suspended gas shipments to Ukraine – grabbing the media headlines and sparking political concerns about energy security in Europe.

Negotiations at both commercial and political levels through 2005 had failed to produce an agreement between Gazprom and the Ukraine gas company, Naftogaz. Gazprom continued to deliver gas designated for transport through Ukraine for redelivery to Gazprom's European customers, but a material volume of that gas was consumed in Ukraine and Gazprom's long-term customers received less than their nominated quantities.

Gazprom quickly increased shipments to ensure full delivery to European customers and minimal suspension, but international questioning continued about the short and long-term reliability of Russian gas supplies.

A January 4 framework agreement came under more criticism, and nearly toppled the Ukrainian government, due to lack of price certainty and the involvement of RosUkrEnergo, a little-known trading company partially owned by Gazprom. The supply/demand stresses of a record cold wave also kept the story current.

On February 2, Gazprom and Naftogaz finalized agreements to implement a resolution. Given the potential impacts on Gazprom's near and far-term prospects, and the magnitude of Gazprom's impact on the lending market over the past year, was and is there any cause for concern?

Deep rooted dispute

The context of this dispute goes back to issues unresolved since Ukrainian independence in 1991. Until 1991, the Russian and Ukrainian economies functioned as a single, centrally planned political and economic web. This integration extended far beyond energy to encompass nearly every aspect of market production and consumption.

Now, the two countries are entering the fifteenth year of the complex transition to arrangements based on numerous commercial, legal, and political aspects of trade between sovereign nations and markets. In that transition, natural gas is just one of many issues that remain contentious. Others include, for example, nuclear fuel and other power issues, rail tariffs, oil products, meat processing, and Russian naval facilities.

When the Soviet Union designed the transportation system to serve its domestic market and undertake large volumes of export gas sales to Europe, the pipelines and storage facilities in the Ukraine were built as an integral part of a unified transit system. Russian gas for Ukrainian supply and gas for export is commingled in the Ukrainian gas transmission network owned by Naftogaz from which Ukrainian gas companies supply their customers all along the transmission system. This configuration makes it impossible for Russia to regulate the volumes of gas taken in Ukraine to ensure delivery of transit volumes to Europe.

Ukraine has become both a big demand center and a key transit region for Russian gas. In 2004, out of total Gazprom's sales to Central and Western Europe of about 148 billion cubic meters (Bcm), about 80% transited across Ukraine. Ukraine itself is the fifth largest gas consumer in Europe after Russia, UK, Germany, and Italy. Its 2004 gas demand of approximately 80 Bcm was primarily supplied by imports from Russia (33.9 Bcm) and Turkmenistan (25.9 Bcm), with the remaining 20.2 Bcm (25%) sourced from Ukrainian production.

In the transitional arrangements formulated after Ukrainian independence, Russia agreed to Ukrainian ownership of the pipeline and storage system within Ukraine. Transit tariffs were negotiated in parallel with gas sales arrangements. Like much Ukrainian international trade, in practice a barter system evolved, with Russian gas exchanged for transit services.

Concerning pricing, the Russia Federation maintained a policy that required Gazprom to provide Naftogaz with politically set prices generally equivalent to Russia's regulated prices under favorable commercial arrangements. This was part of a broader policy exempting Former Soviet Union (FSU) states from normal Russian export terms and conditions until the FSU states assume greater independence and more market-based economies. The rest of Europe paid, and continues to pay, prices pegged to a basket of oil prices and inflation rates under long-term contracts including all the terms and service conditions one would normally expect for such important and large-scale commitments.

Since 1991, Russia and Ukraine have had recurring difficulties with respect to gas supply and transportation. In 1992-93, Gazprom shut off gas flow to Ukraine for a few days over nonpayment. There have been repeated disagreements on applicable pricing for both Russia's gas and Ukraine's transit services, and Gazprom has repeatedly put Naftogaz on notice that gas destined for Western markets tendered for Ukrainian transit has failed to appear at the other end of the pipe. Naftogaz has acknowledged that Russian gas at times has been "siphoned off", and Ukraine has repeatedly failed to make payments for gas takes in excess of the barter arrangements.

The new deal

Few details of February 2 documents have been released, so interpretation must be based on participants' statements and the January 4 agreement.

Under the deal, Ukraine will receive 34 Bcm of Russian and Central Asian gas this year at a price of $95/Mcm, according to Naftogaz. (Naftogaz has a separate contract for 2006 with Turkmenistan for additional import needs.) This is a nearly twofold increase for Ukraine but far less than the $230 it would pay if it were getting Russian gas at export prices. The deal also stipulates that Ukraine will receive up to 60 Bcm of gas annually at the same price formula through the end of 2010, again according to Naftogaz.

According to earlier statements, effective January 1, the transit price set until 2011 is $1.60/Mcm per 100 kilometers, payable in cash. The agreement ends the barter system by separating the transit of Gazprom gas via Ukraine from the Gazprom gas sales price.

A centerpiece of the resolution was the founding of UkrGazEnergo by Naftogaz and RosUkrEnergo to supply gas to Ukrainian industrial consumers, with RosUkrEnergo owned 50-50 by Gazprom and a group of secret investors. In effect, this gives Gazprom access to half of the retail market of the country, with a volume of $4 billion. Gazprom also sees this access as solving the problem of unauthorized tapping of the gas lines.

For Ukraine, the resolution buys Ukraine time to adjust its energy efficiency, fixes an attractive transit rate, and avoids surrendering control over any of the country's lucrative pipelines or underground gas storage capacity.

Ukrainian President Yushchenko said the Ukrainian economy will prepare for the new market conditions and that Ukraine was the first to give up barter schemes by liberalizing gas prices according to transparent and clear contracts provisions.

President Putin praised the end to 15 years of "political considerations and unclear agreements", the enhanced security to European customers through a separate transit contract, and the elimination of subsidy estimated at $3 billion-$5 billion a year (and contrasted to $174 million 2005 US aid to Ukraine).

However, while praising Naftogaz for acknowledging excess gas takes by Ukrainian consumers during January's cold snap, Putin noted that additional agreement would be needed to resolve payment for this gas.

Impact on Gazprom

Due to the newness of Gazprom stock liberalization (nationality restrictions were lifted on ownership of the 49% of Gazprom's stock that is publicly traded on 1 January) the stock-price impact of the Gazprom/Naftogaz dispute is not clear.

In early January, Gazprom moved up 25%, then fell back by February 3 to a 13% 2006 rise. Several analysts switched from "buys" to "hold" or "sell", but these were driven by a view of profit-taking from the 2005 run-up and 2006 expected results. The overall stock price drivers will be appetite for Gazprom by emerging market funds in particular and international investors in general, along with oil price expectations.

In mid-January, Standard & Poor's increased Gazprom's long-term rating from BB to BB+, with a positive outlook, based on both state support and improved stand-alone credit quality. This followed two other credit rating increases in 2005.

In the near term, the new deal seems to be positive to Gazprom's financials, for several reasons. First, it increases the annual revenues from gas sales by an estimated $3-5Billion. Second, it indicates a framework for compensating Gazprom for excessive Ukrainian takes, as occurred in January. Of course, the other side of this is that there is significant Ukraine payment risk. It remains to be seen whether Ukraine can manage the financial transitions it is undertaking, and how much help it will receive from other nations in so doing.

The deal also reduces Gazprom's business risks in two ways: by increasing transport security through separating gas sales from gas transportation and by providing Gazprom involvement in Ukrainian industrial sales.

The deal creates a curious mix of companies, with the partial secret ownership of RosUkrEnergo leaving the fragrance of suspicion in the air. However, the intermediary companies' structures do facilitate the very kind of compromise necessarily achieved, by providing unique flexibility and tax benefits. Ideally, such arrangements would be more transparent, as many also wish for obscure Western tax and trade structures.

Other near-term revenue prospects look positive. Russia is maintaining its program of annually increasing domestic regulated prices to catch up at least partially those prices with needed supply and transportation investments. In 2006, prices for industrial users will be increased on average by 10.4% in rubles depending on the geographical tariff zone, with the range of increase being 9.4-12.8%. With most export prices linked to oil indexes on a lagged basis, many export sales should benefit from price increase for much of 2006.

Medium term prospects seem positive, too. Despite the recent rhetoric, when you put pen to paper Gazprom looks a reliable, cost effective, and environmentally sound bet compared with energy sources in North Africa, the Middle East, or nuclear and coal production. Gazprom and Russia have kept the gas flowing to Europe at extremely high reliability for nearly 40 years, through turmoil much greater than today. Europe's need for Russia's gas seems well balanced with Russia's need for the credit-worthy demand.

Longer term prospects are dominated by large opportunities and challenges. Sitting on huge reserves of 118.8 billion boe (excluding Sibneft), amid rising energy prices, with the unique potential to serve worldwide markets with natural gas via pipeline and LNG, Gazprom has both opportunities that are the envy of the energy industry and challenges that are of daunting proportions. For example, a 2004 analysis concluded natural gas sector investments totaling between $173 billion and $203 billion are needed from 2001-2020. The ability of Gazprom to manage these challenges and deliver on the opportunities will rest on world class management, which is what Gazprom's management says it will deliver.