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UKRAINE: Scope for gas diversification narrows

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Abstract (summary)

Outlook for Ukraine's gas diversification prospects.

Ukraine's Prime Minister Mykola Azarov recently indicated that, over the next few years, Kiev could cease buying natural gas from Russia. His statement reflects Ukraine's aim to have sufficient alternative sources of energy. This has been a policy goal of the current administration, which -- despite its initial image of being 'pro-Russian' -- has been active in pursuing the diversification agenda. So far, the authorities have been able to implement this policy relatively efficiently: gas imports from Russia are being reduced, some additional supply routes have been opened and several global majors are engaged in exploring domestic shale and shelf gas deposits in Ukraine.

Full Text

SUBJECT:Outlook for Ukraine's gas diversification prospects.

SIGNIFICANCE:Ukraine's Prime Minister Mykola Azarov recently indicated that, over the next few years, Kiev could cease buying natural gas from Russia. His statement reflects Ukraine's aim to have sufficient alternative sources of energy. This has been a policy goal of the current administration, which -- despite its initial image of being 'pro-Russian' -- has been active in pursuing the diversification agenda. So far, the authorities have been able to implement this policy relatively efficiently: gas imports from Russia are being reduced, some additional supply routes have been opened and several global majors are engaged in exploring domestic shale and shelf gas deposits in Ukraine.

ANALYSIS: Impacts.

Kiev's increased diversification efforts may prompt Moscow to assume a more accommodating stance on Gazprom 's prices.

Ukraine's ability to import European gas should increase the likelihood of an association agreement with the EU.

If shale gas extraction in Ukraine proves commercially viable, it may have a downward effect on gas prices.

With its gas consumption far exceeding output, Ukraine has always relied heavily on imports of Russian gas. As these imports remained sufficiently inexpensive, the situation appeared stable and was accepted by successive Ukrainian governments without much debate. However, as Russian gas prices increased following the 2009 gas deal, they became an overriding concern for the government that assumed office a year later (see UKRAINE/RUSSIA: Kiev ups pressure for lower gas price - January 30, 2012). The on-and-off gas price talks that ensued have proved futile, as the Russian side refuses to revise the deal. Following the unsuccessful negotiation process, the Azarov government has begun to prioritise gas diversification.

Reduced Russian imports.

Unable to negotiate a lower price, Ukraine has been steadily reducing gas purchases from Russia's sole supplier, Gazprom :

Despite its contractual obligations to acquire at least 42 billion cubic metres (bcm) of gas annually, Ukraine imported just 33 bcm from Gazprom in 2012. Gazprom 's counterpart, Ukrainian state energy holding Naftogaz, acquired only 25 bcm of this gas; the remaining 8 bcm went to private energy giant Ostchem, controlled by a local oligarch, Dmitry Firtash.

This year, according to a late-August statement of President Viktor Yanukovych, Ukraine will import no more than 27 bcm. Accounting for Ostchem's anticipated intake of another 8 bcm, Naftogaz's intake would not exceed 20 bcm. In January-August, total imports from Gazprom reached 11.5 bcm. A local operator Ukratransgaz estimated total January-September imports from Gazprom at 18.2 bcm.

Even a recent jump in purchases from Gazprom -- from around 650 million cm in June to almost 2 bcm in August -- does not change the overall trend. The jump is due to a seasonal acceleration in pumping of gas for storage ahead of the winter season. To ensure sufficient gas transit to Europe during the winter, Gazprom wanted to keep up to 19 bcm of gas in Ukraine's storage facilities, whereas cash-strapped Naftogaz was ready to pump in only 14 bcm. In the end, the sides have reportedly settled on 18 bcm, after Russians agreed to extend a new 2 billion dollar loan to Naftogaz.

Reverse supplies .

Gazprom 's monopoly on Ukraine's gas imports ended when Ukraine began importing gas from Europe. The imports are often referred to as 'reverse' flows, since they involve re-exports of Russian gas sold to European customers. Since average prices charged by Gazprom for European deliveries tend to be lower than prices charged for Ukrainian deliveries, these reverse supplies are cost-effective for Kiev (Ukraine is also paid in this case for transit) but are inevitably limited in scale:

Reverse supplies have been routed through Poland and, since March, Hungary as well. In the first nine months of 2013, their cumulative volume reached 1.5 bcm (809 million through Poland and 680 million through Hungary) out of a total of 2.5 bcm planned for the year.

Reverse volumes could have been much higher had Ukraine secured an agreement on supplies through Slovakia -- a route with the potential to carry as much as 30 bcm of gas per year. However, apart from a one-off test in May, Slovakia is reportedly refusing to allow any re-exports without Gazprom 's consent.

In addition to political difficulties, there are natural constraints to Ukraine's plans to utilise the European route of gas provision. As temperatures across Europe decline, gas supplies to European customers had to be increased, leaving little spare volumes for re-exports to Ukraine. According to local gas operators, in early October daily imports from Hungary halved and, in the case of Poland, stopped altogether. In addition, a jump in gas prices that took place on the European spot markets during the first week of the month has eroded financial attractiveness of reverse imports.

Shale promise .

As part of its diversification strategy, the government seeks to boost domestic gas output, including through extraction of shale gas. This is a direction which has yet to become commercially viable, but which is getting attention from the authorities and producers. After a somewhat protracted pause, the last few weeks have seen significant progress on the two shale development projects:

In mid-September, Royal Dutch Shell signed an operational agreement with its local partner Nadra Yuzovska, which allows it to begin exploration in the Yuzovska field located on the territory of two eastern regions (Kharkivska and Donetska). Shell acquired the right to develop this field on the basis of the production sharing agreement (PSA) concluded with the government in late January.

The Lvivska region council, a provincial legislative body, approved a draft PSA with Chevron on development of the Oleska field in Western Ukraine.

In both cases the government needed to overcome resistance from the ultra-nationalist Svoboda party, the main internal opponent of shale development (see UKRAINE: Shale protests may weaken opposition parties - February 11, 2013), whose popular support is strongest in the west of the country.

The government hopes that together with another project -- development of the Skifska basin on the Black Sea shelf by an international consortium headed by ExxonMobil -- the shale initiatives could more than double Ukraine's overall gas output (from 22 to 52 bcm per year).

CONCLUSION: Kiev appears set to continue its diversification drive -- with the government keen to build on its initial success. However, further progress on diversification may be more difficult. The new gas supply routes appear to hinge on Europe-bound transit volumes of Russian gas through the Ukrainian territory, which are declining. Likewise, extraction of shale gas is a long-term and uncertain prospect.

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