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Prof. Andrey Konoplyanik Image credit: Коммерсантъ/ Petr Kassin

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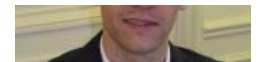
## EURASIAN MANOEUVRES OF RUSSIA: INTERVIEW WITH ANDREY KONOPLYANIK

Natural Gas Europe was pleased to have the opportunity to interview Andrey Konoplyanik, Professor at the Oil and Gas Gubkin Russian State University, Adviser to Director General of Gazprom Export LLC. This interview is based on conversations held on October 21st and October 30th.

**Natural Gas Europe (NGE) :** Agence-France Press reported that Russia and Ukraine made progress toward resolving a dispute over gas supplies during the meetings in Milano (on 17 October). What is your perspective about recent Russia-Ukraine deal? Did Russia have to compromise?

**Andrey Konoplyanik (AK):** - Milano was followed by the meeting in Brussels (on 21 October). I think Russia and Ukraine will finally agree on some key issues. My firmness is connected with the fact that Gunther Oettinger is going to leave together with all current Commission at end-October and he wants to finish on good terms. In addition, dispute over Russian gas supplies to Ukraine should be resolved shortly since this country will not survive this winter without Russian gas, as was officially recognized by Ukrainian Prime-Minister Arseniy Yatsenyuk, and Ukraine's settlement of debts for already delivered gas (starting from supplies in November and December 2013) is an essential condition for reopening of Russian gas supplies. Payment scheme can be various, the main thing is an agreement on the fact of the payment and obligation to fulfil the obligatory - to finally pay the debt. There are different sources of the obligatory payment: either \$3.1 billion from IMF loan or European institutions – Vladimir Putin mentioned some major first-class banks that can be loan sponsors or provide financing for Ukraine. That is why I think that payment and scope of delivery till March within a temporary scheme to pass the winter peak will be agreed. Most likely the parties will fix some temporary price that will be understood by each side in a different way. For Russia \$385 per 1000 cubic meters means current oil-indexed price minus \$100 (equal to custom export duty) – under such approach we can maximize our resource rent through oil-indexation pricing mechanism. Maximization of resource rent for producer state resulted from the principle of sovereignty on natural resources by the sovereign state is protected by international law since UN GA Resolution 1803 as of December 1962 and further on by Art.18 of the Energy Charter Treaty since 1994/1998. Russia and Ukraine have since 2009 this contractual formula in our 10-year supply contract that brings to life such price levels - and it is still in force. As for the discount, it is a gesture of unilateral good will of Russian state for Ukrainian people to soften for them transition through the winter season (non-

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dependent political disagreements with current Ukraine's authorities) while this country still do not have adequate alternative supplies and is short in financial resources. Ukraine itself has another perspective today: they don't want to depend on Russia and its unilateral favours, therefore they represent the same price in another way. This price level in their view is connected with an average price on the Western-European spot market plus expenses on transportation back to Ukraine. I think the sides will agree on a temporary price level around \$385 and put the argument about pricing mechanism aside. After the winter peak we can await other rounds of discussions and other decisions.

**NGE:** So, in any case Ukraine will have to pay.

**AK:** Yes, that is a minimal prerequisite. Ukraine has to pay debts before moving on.

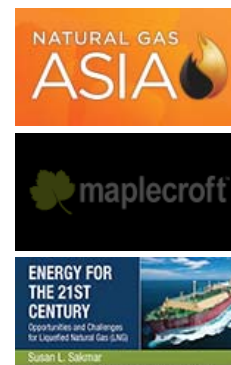
**2) NGE:** As a response to Western sanctions Russia started to turn to the East. What are the prospects of China-Russia projects and Russia as a possible swing supplier?

**AK:** The fact that Russia signed a deal during the period of sanctions doesn't mean that it was a result of the cooldown with our Western partners. I would say it made the negotiation process faster, though. Since early 2000s Russia announced that it would aspire to turn to the East in the event of increasing risks and uncertainties at the European energy markets. This statements reflected institutional developments at EU energy markets in result of the 2<sup>nd</sup> and 3<sup>rd</sup> EU energy packages (which added such incremental risks and uncertainties on external suppliers) and of enlargement of the EU when its borders moved to the East and delivery points of Russian gas turned out to be since then deep inside the EU which means loss of the control by the supplier on the big segments of the gas value chain destined for the EU. The unpredictable possibility of influence by the third party on the gas transit supplies from Russia to the EU and the diminishing "security of demand" due to institutional developments in the EU market have led to increasing risks and uncertainties for Westward-oriented export supplies of Russian gas. . Moreover, many Russian institutes, for example, Russian Academy of Sciences' Energy Research Institute headed by Academician Alexei Makarov, pushed forward long ago the idea that Russia should aim at both Europe and Asia to have a cross-flow option. Actually we have three interlinked markets – interlinked via Russia: European, Russian domestic and Asian, each of them is quite large, and Russia can balance between them. This Eurasian balance requires sufficient infrastructure to provide cross-flows and make Russia feel comfortable when access to some markets is restricted or demand is going down. So the logic of the Asian projects realization is not connected with recent sanction, because the turn to the East started a long time ago and it is a long-term and fact-based trend.

Though one need to distinguish between two major Russian East-oriented gas projects: "Power of Siberia" project that links Russia with the Asian/China market (via so-called Eastern route), and "Altaï" project which is not only linking Russia to the Asian/China market via another (so-called Western) route, but – which is much more important from my view – bringing potential flexibility to Russian supplies by providing a choice in future supplies (after existing contracts in EU will expire): either to renew (at least in part) the contracts with EU, or to redirect some of newly available contractual volumes to the East.

**NGE:** Do you think that conditions of the "Power of Siberia" are profitable for Russia?

**AK:** I don't know the pricing formula and can't see the whole picture but from my point there are at least two good moments for Russia in the supply contract itself which enabled construction of "Power of Siberia" pipeline. Negotiations with China have never been easy for our country. First moment is that from the beginning China insisted on the coal-based indexation pricing. Our countries needed pricing formula anyway because spot price in long-term contracts is impractical (even more, China doesn't have a spot market and connection with a Japanese one would be nonsense). China is the largest consumer of coal in the world (so it faces huge ecological problems in the North-East – final destination of Russian gas), so finally gas will be competing with coal and replacing it. Comparing to clean Russian gas Chinese dirty coal is cheaper. It is also cheaper than oil. That's why for importer coal-based indexation pricing would be better than oil indexation. Russia managed to insist on oil indexation-based pricing – it is the first moment of our victory (mechanism of indexation predetermines the level of future prices). The question is: why did it happen? My presumption is that it happened because Russia persuaded China that we conclusively and irrevocably decided to make Vladivostok LNG project. In this case Russia receives a room for manoeuvres: either sell pipeline gas to China or sell it as LNG at the Asian market, including to China as well. LNG market pricing is based on oil indexation (in Asia – on price of Japan Crude Cocktail/JCC). This is an additional reason for Russia to suggest oil indexed pricing. Otherwise we would transfer gas from Vladivostok LNG through the seashore and it would come to China as LNG with oil indexation. Gazprom is involved in the "Sakhalin-II" project with first ever LNG supplies from Russia, but this gas is aimed mostly at Japan, so



with China we can negotiate only about «new» gas. This «new» gas China can get through the pipeline for the Chinese market and then our negotiating capacity is not so strong. But as soon as we said that a part of supplies would go to Vladivostok LNG and from there to foreign market – Russia immediately got a powerful negotiating tool. After all, the indexation mechanism is necessary to diminish price fluctuations which is both helpful for long-term supplier and his customer. As for the investment programme of Gazprom, we understand that China-oriented part is de-facto protected from sanctions because Chinese market is ready to provide financing and \$25 billion loan as prepayment if necessary. Second point, the gas for export will go as dry (processed) gas and not wet (rich) gas full of ethane and higher fractions (a feedstock), helium, etc. All these fractions will be extracted in Russia before delivery point at the border, so this project will stipulate development of gas-processing industries in the Russian Far East. And, finally, “Power of Siberia”, as each infrastructure project, will create huge multiplier effects through the whole Russian economy, means for adjoining industries and people involved.

**NGE:** As our interview was ready to be published the news has come that on 30 October Russia, Ukraine and the EU have signed Protocol clarifying conditions of Russian gas supplies to Ukraine through Winter season 2014/15. NGE approached Dr.Prof.Konoplyanik to comment on this agreement.

**AK:** It seems that everything that we were speaking about two weeks earlier has been reached in practice. (Now former) EU President Barroso has been underlining the special role of the EU and Commissioner Oettinger in reaching temporary compromise between Russia and Ukraine, and that the compromise was reached on the basis of the plan proposed by the EU. Nevertheless, in the trilateral “Binding Protocol” that was signed on October 30 for the period since November 2014 till 31 March 2015, I see almost all major items that were voiced by the Russian side through the period of trilateral consultations except “take or pay” provision which Gazprom will forgo to invoke for the above-mentioned period. The pricing formula is that from the 2009 Supply Contract between the parties, the purchase price is decreased by the amount of export duty provided by the Government of the Russian Federation (up to 100 USD/1000 cu meters), the prepayment scheme is there, payment for transit services will be done in accordance with Transit Contract of 2009 between the parties. The mechanism and schedule of debt repayment is explained though the parties has expressed in writing their different understanding of what the sum of payment (3.1 USD bln) does constitute – whether it is full (Ukraine, based on price 268.5 USD/1000 cu meters) or partial (Russia, based on contractual price as defined in the Supply Contract) payment.

*About Andrey Konoplyanik: Prof. Konoplyanik published more than 500 articles on energy issues both in the USSR/Russia and abroad (all available at his website - [www.konoplyanik.ru](http://www.konoplyanik.ru)), including the recent publication in three parts “The Role of 'European formulas' in the Russia-Ukraine Gas Debate” in the “European Energy Review”. He also known, inter alia, as Deputy Minister for Fuel and Energy, responsible for external economic relations and direct foreign investment, in the first post-Soviet Russian Gaidar’s Government in the early 1990s, Deputy Secretary General of the Energy Charter Secretariat in Brussels in the 2000s.*

### **Marina Zvonareva**

Marina Zvonareva is a Natural Gas Europe analyst focused on Russia’s international energy relations. Follow her on Twitter: [@ZvonarevaMar1na](https://twitter.com/ZvonarevaMar1na)

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