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SIPDIS

DEPT FOR EUR/UMB,  
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Classified By: Acting Economic Counselor William Klein for reasons  
 1.4 (b) and (d)

1. (C) Summary. The ongoing gas price discussions for 2009 once again highlight Ukraine's strong dependence on energy imports from Russia: Ukraine depends on Russia for 80 percent of its natural gas, 61 percent of its oil, 100 percent of its nuclear fuel, and for the disposal of all the fuel it burns in its nuclear power plants. This near total dependence on Russia has left Ukraine little negotiating room with its northern neighbor. Successive governments have acknowledged that Ukraine can reduce this dependence by developing domestic resources and improving the energy efficiency of Ukraine's wasteful economy. Ukraine possesses significant untapped gas and oil reserves, and the country is making slow and halting progress towards reducing dependence on Russia in the civil nuclear sector. However, a lack of political will, shortsightedness, bad policies, a shortage of capital and distrust of foreign investment, combined with a negotiating partner that has proven to be far savvier than its Ukrainian counterparts, have prevented Ukraine from reducing its dependence on Russia. To diversify sources of energy and reduce its dependence on Russia, Ukraine will need to improve energy efficiency, eliminate corruption, boost transparency, and open the sector to foreign investment, during increased political uncertainty in Kyiv. End summary.

Natural Gas: 80 percent from Russia  
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2. (SBU) Currently, Ukraine is dependent upon Russia for 80 percent of its gas. Nominally, the majority of this gas comes from Central



Asia, yet Russia has full control over all gas sold to Ukraine from the East. Until 2006, Ukraine was confident that its strategic

position as the chief conduit of Russian gas to Western Europe would guarantee it cheap prices indefinitely. Things changed drastically when Russia actually cut off gas to Ukraine for two days, however.

3. (SBU) Gas prices have increased from \$50/tcm in 2005 to \$179/tcm this year, and both Russia and Ukraine agree that Ukraine will soon need to pay roughly Western European prices for its imports. An October 2 Memorandum of Understanding between Russian Prime Minister Putin and Prime Minister Tymoshenko foresees a long-term contract that will gradually bring Ukraine closer to market prices over the next three years while eliminating the infamous gas middleman RosUkrEnergo (RUE). (Note: Naftohaz Chairman Oleh Dubyna explained in the press that a long-term contract means a contract valid until

2019. End note.)

4. (SBU) Ukraine has failed to use its gas pipeline and storage system to its full advantage in its dealings with Russia. Ukraine is the world's largest transit country for natural gas, transporting 110-120 billion cubic meters (bcm) of gas to Western Europe every year. Although volumes continue to rise, Gazprom pipeline projects Nordstream and South Stream will reduce Russian dependence on the Ukrainian transit pipeline and further weaken any hope for Ukraine that it could use its pipeline to its negotiating advantage. In addition, Moscow in recent years concluded long-term contracts with Central Asian producers that permit only Russia to buy most of Central Asia's gas, blocking any efforts on Ukraine's part to bypass Gazprom by purchasing Central Asian gas directly.

5. (SBU) It would seem logical that, in return for paying market prices for gas, Ukraine could charge Russia market prices for transit and storage. Currently Ukraine charges Gazprom \$1.70/tcm/100 km in transit fees, while the EU average transit rate in 2007 was \$7.04/tcm/100 km, or four times higher. Ukraine also receives only \$2.25/tcm for gas storage, while Hungary earned \$25/tcm in 2007. Although many Ukrainian officials have said that Ukraine needs to renegotiate both gas transit and storage fees, the 2004 agreements prohibit the GOU from doing so until 2029.

The Alternative: Developing Domestic Gas Reserves

6. (SBU) Ukraine could reduce dependence on Russian gas imports by developing the large gas reserves in the Black Sea and in the interior of the country. Ukrainian geologists estimate that with the proper technology and investment Ukraine has enough gas to meet domestic consumption for hundreds of years. However, various governments have repeatedly thwarted development of these resources with bad policies. Severe caps on the sale price for domestically produced gas have discouraged production and exploration and led to a grey market that has furthered corruption in the already non-transparent gas sector. The Tymoshenko government's unilateral abrogation of the Production Sharing Agreement with Houston-based Vanco will freeze development in the Black Sea until the dispute is resolved. The government's action is also acting as a strong deterrent on foreign investors' willingness to commit to the large-scale, long-term type of capital investments that domestic exploration requires.

7. (SBU) Ukrainian energy experts estimate that as much as 3.5 trillion cubic meters of coal methane could be captured, which could boost domestic gas production by 40 percent. So far, however, the GOU has failed to take any steps to exploit coal mine, coal bed, or abandoned coal mine methane capture. For years, U.S. and other

foreign companies have expressed interest in developing methane capture projects, but have received little or no interest from the GOU or Naftohaz. Both insist that subsidiaries of Naftohaz eventually will have the financial and technical capability to capture methane themselves. Ukraine also is unwilling to pay for costly pipelines and additional storage facilities that would be needed for methane capture. Despite Naftohaz's official line against foreign investment, some company contacts have told us that barring an influx of much-needed foreign investment and technical know-how, methane most likely will remain underground, making coal mines more dangerous while polluting the environment further.

#### Dependence on Russian Oil

8. (SBU) Oil is imported primarily for producing gasoline and diesel fuel, with 61 percent from Russia and the remainder produced domestically. Ukraine imports 70 percent of its gasoline and diesel, not from Russia, but from Romania, Belarus, and Lithuania. Nonetheless, Ukraine's main suppliers of gasoline are of course dependent on crude oil imports from Russia, giving Russia additional influence on Ukraine's gasoline and diesel supplies. Moreover, gasoline imports from Russia could rise significantly if Russia makes good on talk of reducing export tariffs for refined gasoline.

9. (SBU) Of the six oil refineries in Ukraine, Russian companies own the Lysychansk refinery in eastern Ukraine (TNK-BP), the Odesa Oil Refinery (Luk Oil), while the Tartarstan Republic (part of the Russian Federation) and the Russian company Tatneft are battling for legal control of the Kremenchug Refinery in Central Ukraine. Ukraine is also an important transit country for Russian oil exports to Western Europe, having transported 26 million tons (Mt) through the Druzhba pipeline and another 14 Mt through the Prydniprovski pipeline in 2007.

#### Alternatives to Russian Oil

10. (C) Ukraine could reduce its dependence on Russian oil by further developing onshore resources and by tapping the reserves of the Black Sea. However, as with the case with gas, developing the oil resources of the Black Sea will make little progress until the PSA dispute with Vanco is solved (ref D).

11. (C) The Odesa-Brody pipeline is Ukraine's most manifest attempt to reduce dependence on Russian crude oil. Ukraine has always hoped to pump Caspian crude from Odesa to Brody, a town in western Ukraine that is linked to the Druzhba pipeline. The pipeline was completed in 2002 under President Kuchma. Both Kuchma and successive governments believed that business would surface once the pipeline was built, despite repeated advice by foreign experts that the project lacked a sound commercial underpinning. (Comment: Some observers argue that the project was primarily conceived as a cash cow for Interpipe, the pipe producer owned by Kuchma son-in-law Victor Pinchuk. End comment.) The pipeline remained empty until 2004 when TNK-BP and Transneft concluded a contract with the GOU to transport Urals crude in the opposite direction, from Brody south to Odesa. In 2007, TNK-BP shipped more than 9 Mt of Russian oil through the pipeline.

12. (SBU) President Yushchenko has revived efforts to re-reverse Odesa-Brody with the hope of off-taking a percentage of oil to be refined at the Nadvirna and Drogobych refineries in western Ukraine. In order to achieve Yushchenko's goal, Ukraine would need to reconfigure an existing refinery to refine Caspian crude or invest in the construction of a new refinery, which could cost up to \$4 billion. Yushchenko also aims to transport Caspian crude northward

via the pipeline to Europe. So far, Ukraine and potential partners

Poland, Azerbaijan, Lithuania, and Georgia have failed to reach an agreement that would provide adequate supplies of Caspian oil needed to secure the re-reversal of Odesa-Brody.

#### Dependence in the Civil Nuclear Sector

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13. (C) Little attention has been paid to Ukraine's complete dependence on Russia for its nuclear fuel supplies. Ukraine's state nuclear energy generating company, Energoatom, currently buys all of its nuclear fuel from the Russian state-owned company TVEL via long-term contracts that require annual price negotiations, similar to the arrangements for natural gas. Ukraine's 15 nuclear reactors generate 50 percent of the country's electricity; a disruption of nuclear fuel supplies and continued lack of domestic spent fuel management infrastructure could be catastrophic for Ukraine. Ukraine Energy expert Frank Lemkey told us that most Ukrainian politicians are so concerned about natural gas supplies that they fail to recognize Russia civil nuclear leverage.

#### Alternatives to Russian Nuclear Fuel and Storage

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14. (C) In an attempt to diversify its nuclear fuel supplies, Energoatom in 2008 signed a contract with Westinghouse to provide nuclear fuel for three of Ukraine's reactors beginning in 2011, which would cover 20 percent of Ukraine's nuclear fuel needs. Westinghouse has reported that TVEL has attempted to thwart the Westinghouse deal and any future deals by telling Ukrainian officials that Westinghouse fuel is 30 percent more expensive than TVEL's fuel and that Westinghouse has hoodwinked Kyiv. Westinghouse representatives have countered that TVEL's last three annual negotiations with Energoatom have resulted in price increases for TVEL-provided fuel, which in the next few years would significantly close the price gap between Westinghouse and TVEL.

15. (C) Westinghouse has offered to supply fuel to three additional Ukrainian reactors at a fixed price if Energoatom agrees to expand the existing contract by March 2009. Westinghouse also is willing to transfer technology to Ukraine, provide a fuel fabrication facility, and engage with Ukrainian industry for the supply of some fuel components. However, there are reports that Ukraine may sign long-term contracts with TVEL for fuel supplies through 2025 and form partnerships with Russian companies to construct a fuel manufacturing facility.

16. (C) Ukraine pays about \$150 million in annual fees to Russia for storage and reprocessing of spent nuclear fuel. Russia has significantly increased these fees during the past three years. If Ukraine refused to accept terms and conditions dictated by Russia for spent fuel storage management, the lack of on-site and central storage facilities would choke half of the Ukrainian nuclear energy sector. Although Ukraine's Energoatom signed a contract with U.S. company Holtec International in 2005 for the construction of a Central Spent Nuclear Fuel Storage Facility, progress on this project has been very slow and political obstacles continue to hinder the realization of this important facility.

#### Little Done in Energy Efficiency, Alternative Fuels

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17. (U) Ukraine could also reduce its dependence on Russian energy imports by increasing energy efficiency. Energy consumption per unit of GDP is among the highest in the world. When consumption is measured in such terms, Ukraine uses twice as much energy as the EU, 2.7 times as much as the USA, and 6.5 times as much as Japan. Private industry, and in particular the largest, export-oriented industries, have invested heavily in recent years to reduce their energy consumption. At the same time, energy waste is particularly

severe in the municipal heating sector, where the Soviet-era infrastructure has received little new investment since independence in 1991.

18. (C) The GOU created the National Agency for Effective Use of Energy Resources (NAER) in December 2005 to boost energy efficiency. NAER Head Ihor Cherkashin told EconOff that the NAER has yet to gain sufficient support from the Parliament and other ministries. Cherkashin said that some ministries have taken the energy efficiency mission as their own responsibility and do not coordinate efforts through the NAER. He added that the NAER has programs for increasing efficiency for municipal heating, water supply, natural gas, and industrial sectors such as steel production and food production, but little funding has been allocated to the NAER. These programs have made little progress as a result.

19. (SBU) Ukraine's vast agricultural potential could make it attractive location for the production of biofuels. The idea of using food to make fuel is extremely controversial in Ukraine, however, and little has been done to develop biofuel projects (although significant rape seed production is exported to Western Europe for the production of biodiesel). Biofuel legislation, which many Ukrainian experts say would need to include subsidies for farmers and biofuel producers, has yet to be passed by the Rada (parliament).

20. (SBU) Hydropower, generated mostly through vast Soviet-era hydroelectric plants on the Dnipro River, accounts for about five percent of the country's power needs. Although the potential in most of the country is now exhausted, experts believe that hydropower can be expanded successfully in the mountains of western Ukraine. Wind and solar account for less than one tenth of a percent of electricity generation. While various GOU officials have given lip service to the need to further develop renewable energy, few concrete steps are actually being taken.

21. (C) Comment. Ukraine has been considerably weakened by its current financial, economic, and political instability as it attempts to negotiate with Russia over gas prices and supplies. Kyiv is not in position to drive a hard bargain with Gazprom for gas or with TVEL for nuclear fuel. Ukraine's reliance on its position as Russia's largest transporter of natural gas to Europe has created a false sense of energy security. Ukraine will need to improve energy efficiency, eliminate corruption, boost transparency, and open the sector to foreign investment if it hopes to diversify sources of energy and reduce dependency on Russia. That will require a long-term vision and a strong political will, all of which are in short supply in the current political environment. End comment.

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