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Russia's Rationale for Expropriation of Ukrainian Black Sea Gas Resources

By Maksym Bugriy[1]

Russia's annexation of Crimea is mostly interpreted as a strategic military grab, while the question of annexed Ukraine's economic assets remains behind the scene. But the expropriation of Ukraine's natural gas and oil reserve assets is worth special attention: the Crimean operation, which became a model case in "hybrid warfare", could also contain "hybrid ends". Perhaps, the Kremlin also considered control over the Black Sea gas fields as an important strategic objective.

By today, Ukraine had filed several legal suits stating the damage of the annexed Crimean assets. The latest case brought by Naftogas Ukraine before the Hague's international arbitration claimed $2.6 billion in damage for expropriating the assets and extracting gas in Crimea.

The expropriation of Ukrainian gas fields could be examined in the framework of the Russia-Ukraine territorial conflict, but also following the body of "resource wars", and applying the logic of geo-economics. It does not matter which approach is taken as each situation shows that it was hardly the energy security of Crimean residents that was Russia's primary motive.

With the annexation of Crimea in 2014, Russia appropriated the oil and gas in the Black Sea shelf reserves owned by the people of Ukraine, and exploited by Ukrainian state-owned company Chornomornaftogas. The Crimean "government" nationalized this company, thus securing its assets by an armed "militia" in March

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2014. As a result of that, Chornomornaftogas lost the control over almost all of its gas assets, which included eleven natural gas, four gas condensate and two oil fields. The company had estimated the balance of its oil and gas reserves to be at approximately 59 bcm of natural gas, 1,231 tonnes of gas condensate and 2,530 tonnes of oil.[2]

Additionally, Russia seized Hlibovske, which is an underground gas storage facility with 1 bcm capacity and some 18 million cubic meters of gas stored. Remarkably, President Vladimir Putin twice, in January and November 2016, allowed some of the supply of gas from the Hlibovske facility to the Ukrainian city of Henichesk.

Kremlin declaring the gas assets "Crimean" property was so dubious that even the Russian industry outlet interpreted the expropriation of the Ukrainian resources as a "prize" implying certain "luck". "Neft Rossii" entitled its March 2014 note "The Black Sea Shelf: what the Crimeans have "Profiteered" [разжились]".[3]

Indeed, "profiteering", and not "energy security" could be the primary reason for the Crimean resources annexation. In the framework of the conflict with Ukraine over Crimea, Russia uses the gas resources to economically isolate the peninsula and deprive Ukraine of its economic leverage. Russia "cloned" the Chernomorneftegaz entity that accelerated the volumes of shelf drilling and gas output. Crimea consumes 1.5-1.6 bcm of natural gas per year and, that was the annual extraction volume for several years preceding the annexation.

While the Ukrainian company planned to significantly increase the extraction to add to the nation's energy independence, it lacked the will and resources to do so. But it was Russian Chernomorneftegaz

[2] Росія незаконно видобуває на шельфі Чорного моря 2 мільярди кубометрів газу на рік – "Чорноморнафтогаз". *Unian* [online]. 2016-11-03 [seen 2016-12-06]. Available from: http://economics.unian.ua/energetics/1604421-rosiya-nezakonno-vidobuvae-na-shelfi-chornogo-morya-2-milyardi-kubometriv-gazu-na-rik-chornomornaftogaz.html

[3] Справка: Черноморский шельф - чем разжились крымчане. *Neft Rossyi* [online]. 2014-03-13 [seen 2016-12-06]. Available from: http://www.oilru.com/news/401663/

that extracted 1.8 bcm natural gas and 61.1 thousand tonnes of oil and gas condensate and commissioned five new wells in 2015.

The increased extraction was aided by Russia's use of two modern rigs, the "Petro Hodovanets" and "Ukraine", that Ukraine acquired in 2012. According to Razumkov Centre's energy expert Viktor Logatskiy (author interview, October 2016), the stolen rigs are presently the most technologically advanced equipment in the Black Sea area. Furthermore, these rigs were removed from their drilling sites, where Ukraine had installed them, using naval vessels as convoy protection.

Russia is relying on Ukrainian Crimean gas to fill the capacity gap in electric power generation, avoiding a possible Ukrainian energy blockade, while striving to achieve the highest possible degree of Crimean energy self-sufficiency. Russia recently laid an underwater cable connecting the peninsula with the Russian electric power grid, but also brought several small capacity gas-fired power generation stations and eyes larger gas-fired electric power station projects. At the same time, the increased output by Chernomorneftegas led to the accumulation of gas in Hlibovske storage, which also put pressure on Russia to buy gas-fired electricity plants. By 2018, Russia has committed to construct two gas-fired electric generation plants 470 MWt each.

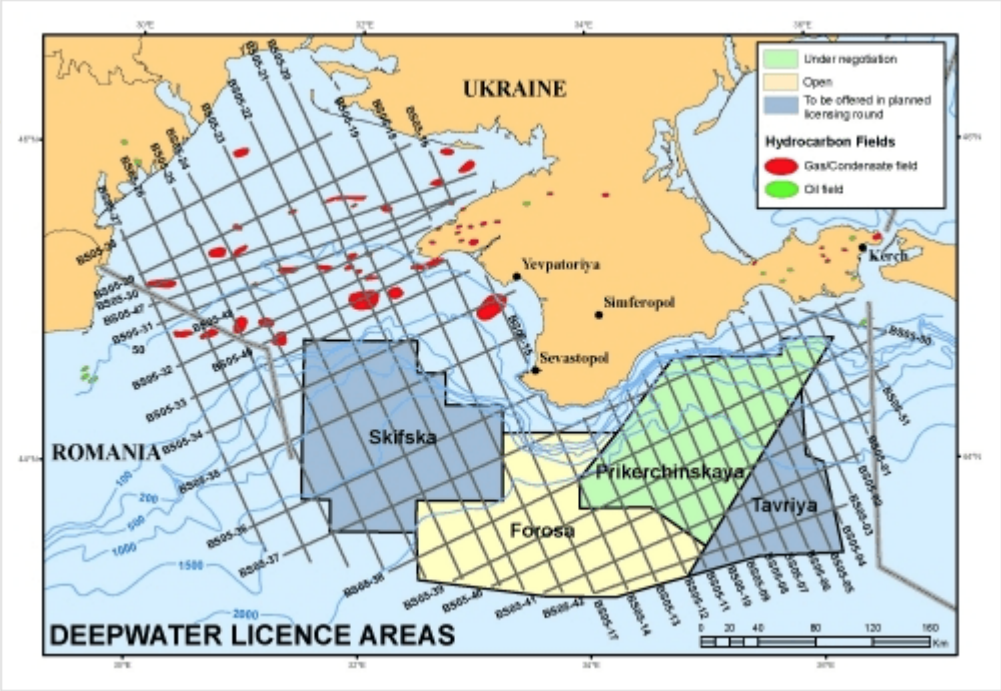
Remarkably, the electricity and gas themes were exploited in the disinformation operations component of the conflict with Ukraine: recently, the Russian Security Service FSB seized two Ukrainian military analysts residing in Crimea accusing them of planning sabotage against mobile gas-fired power generation stations.

But Russia's "profiteering" logic seems to prevail when looking at the underwater "Krasnodarskiy Kraj – Crimea" gas pipeline that Russia pledged to build by 2018. Even considering Crimea's annual natural gas demand exceeding the current 2 bcm used for consumption and storage in annexed Hlibovske facility, the planned capacity of 4.4 bcm in the new pipeline is far above the

requirement. Perhaps, Russia could use this extra capacity at some point to supply Gazprom's natural gas to South Ukraine after 2019, when the current Russia-Ukraine gas supply contract expires. But energy observers do not exclude that Russia envisages the reverse flow of the system, thus bringing annexed Ukrainian gas resources to the market.

The potential of the Ukrainian Black Sea gas resources could be significant. Besides confirmed reserves, there are also potentially an attractive Black Sea shallow shelf, and deep-water resources.

Ukrainian Deepwater Oil and Gas Licence Areas



In 2012 – 2013, Ukraine signed with ENI, Shell and Chevron Production-Sharing agreements (PSAs) to develop those resources, which were at that time assessed as having high potential. In the spring Ukrainian Energy Minister Yuriy Prodan evaluated Ukraine's

loss of control at $40 billion.[4] For example, Prykerchenske natural gas and oil deposit allocated for use by the company Vanco Prykerchenska includes an estimated 180 bcm in deep-water natural gas reserves as well as 83 million tons of oil.[5]

In 2012-2014, Ukraine negotiated the development of Skifske bloc, which could potentially produce about 5 bcm of natural gas per year with Exxon Mobil-led consortium that also included Shell and Romanian OMV Petrom, while simultaneously rejecting Russia's Lukoil bid. The dysfunctional Yanukovych administration lost the opportunity to timely enter the PSA, where the exploration was due to begin in 2015. In yet another development related to Eastern Crimean oil fields, Ukraine signed a PSA with Italy's Eni S.p.A. and France's EDF in late November 2013, shortly after the beginning of Maidan protests in Kyiv. There was a hope to produce up to 3 million tonnes of oil per year from this venture[6]. All these projects are of great importance to Ukraine's energy independence from Russia, and they were either abandoned, or put on hold immediately after Crimea's annexation.

An important variable to consider in this analysis is the effect of the current and projected low hydrocarbon prices, which makes these developments less economically attractive. But the appetite has not yet vanished: Lukoil, for example continues its exploration activities with Romanian Black Sea reserves. Russia's militarization of Crimea, in the meantime, has virtually moved the "nowhere-ending" (according to President Putin's recent joke) Russian border to Romanian exclusive economic zone, where Lukoil is operating.

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[4] BUGRIY, Maksym. The Cost of Ukraine of Crimea's Annexation. *Euraisa Daily Monitor* [online]. Volume 11 Issue 70 [vid. 2014-06-14]. Available from https://jamestown.org/program/the-cost-to-ukraine-of-crimeas-annexation/#sthash.jqBmBlZE.dpuf

[5] BUGRIY, Maksym. 2014 (see reference 5)

[6] Ukraine Signs Oil, Gas Deal With Eni And EDF, Sees $4B Investment. *Rigzone* [online]. 2013-10-27 [seen 2016-12-06]. Available from**:** http://www.rigzone.com/news/oil_gas/a/130334/Ukraine_Signs_Oil_Gas_Deal_With_Eni_And_EDF_Sees_4B_Investment

The Kremlin is likely to exert considerable pressure and offer „sweetners" to littoral and regional states that are key nodes in the EWU Southern Gas Corridor: Georgia, Bulgaria, Romania and Turkey. The Kremlin also seeks to have more control over the Turkish Straits, and not to allow global LNG to the EU market via this gateway. Thus, Gazprom could potentially continue to be the main gas supplier to the EU.

Notably, Russia's doctrinal thinking preaches the concept of resource-driven power relations. It continues to cultivate the beliefs of resource domination and framed by the vision of energy geopolitics. Ukraine managed, albeit at a high cost of human and material losses to achieve relative independence from Gazprom. It has not bought Russian gas for a year directly, at the same time Gazprom seems to be content with Ukraine helping to increase its Europe exports with reverse purchases of gas – analyst Korchemkin concluded that Ukrainian transit assured an 82 percent share of Gazprom's growth over its 10 months 2016 EU exports.[7]

Another known Russian energy expert Mikhail Krutikhin believes that Gazprom would still continue to rely on Ukraine's GTS after 2019.[8] Seeking to maximize its share, Russia aims to diminish Ukraine's and other Black Sea states suppliers, and transit roles using what it is best at: military intimidation.

The West, increasingly factured in its transatlantic partnership, may well lose its sanctions grip, which would allow Moscow to attract multinational corporations as investment partners, gaining critically important technological competencies in the development of extracted Ukrainian resources.

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[7] KORCHEMKIN Mikhail. Газпром укрепляет сотрудничество с Украиной . In *ЖЖ Михаила Корчемкина* [online]. 2016-10-14 [seen 2016-12-06]. Available from**:** http://m-korchemkin.livejournal.com/778012.html

[8] SHEREMETEVA, Svetlana. Газова залежність Росії від України збережеться і після 2019 року. *Apostrophe* [online]. 2016-06-10 [seen 2016-12-06]. Available from: http://apostrophe.ua/ua/article/business/energy/2016-06-10/gazovaya-zavisimost-rossii-ot-ukrainyi-sohranitsya-i-posle-2019-goda/5535

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Of course, this is still a speculative risk, as it does not factor in Russia's business management and capital capacities. Yet, Moscow is also learning along the way: the risk of Western loss is real concerning Black Sea energy affairs. While Ukrainian-Russian legal disputes over the annexed assets could be a showcase in the validity and resilience of the international law, it may also trigger the process to find an eventual solution to the regional rebalancing.