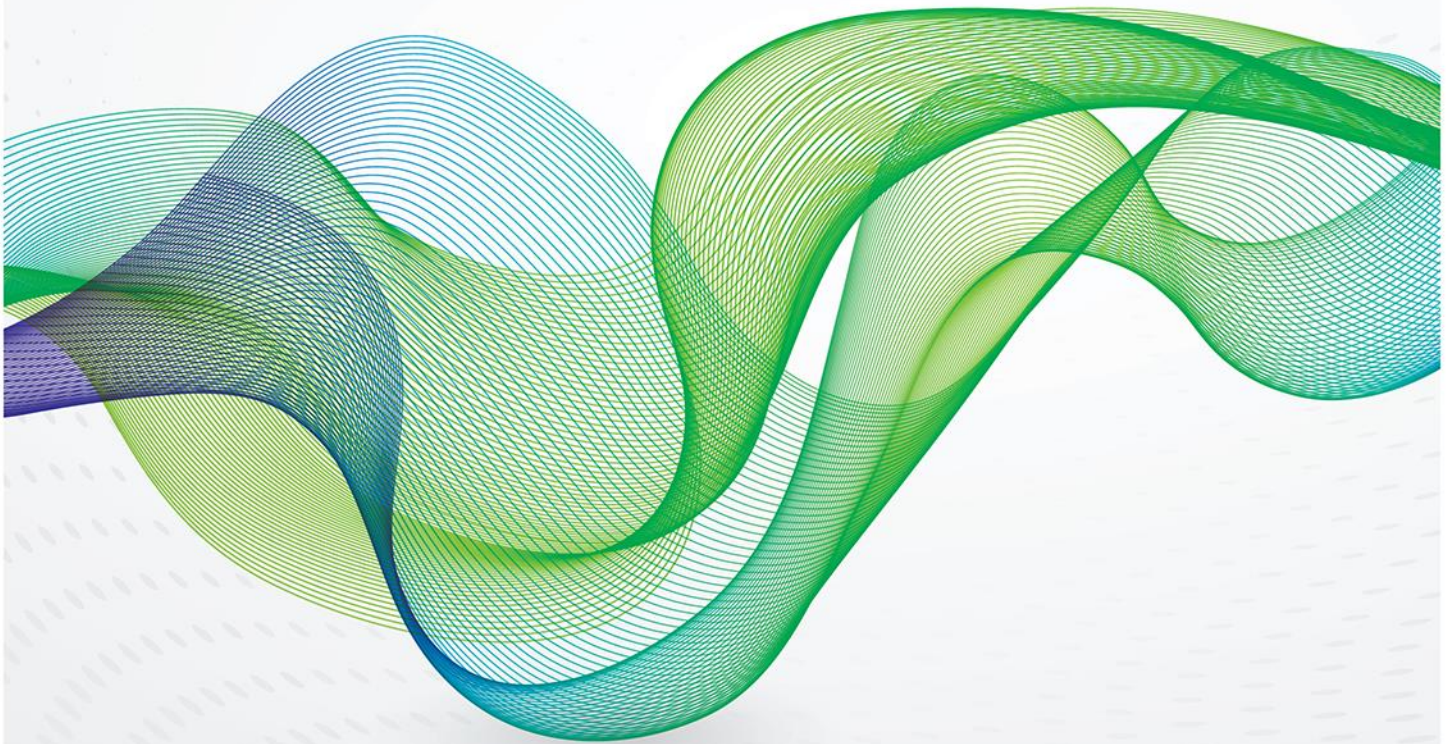




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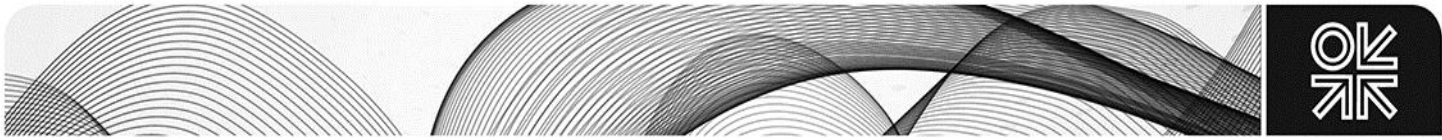
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Russia-Ukraine transit talks: the risks to gas in Europe



OXFORD ENERGY COMMENT

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Introduction

Trilateral talks between the European Commission, Russia and Ukraine on arrangements for gas transit across Ukraine from January 2020 are expected to resume in late May. While the commercial logic for putting arrangements in place is obvious, for both Gazprom and Naftogaz Ukrainy, political factors are elevating the risk that no agreement will be reached by 31 December, when the current transit contract expires. The supply interruption that may result would, in the first place, impact consumers in Ukraine and south-east Europe. It might also produce a broader political risk to the position of gas in European energy markets, reinforcing doubts about Russia's role as a reliable supplier, and arguments that gas should not be seen as a destination fuel for the energy transition.

The background to the talks is that, while Gazprom continues its efforts to diversify transit away from Ukraine, the two principal alternative routes under construction – Nord Stream 2 and Turkish Stream – will certainly not be fully operational by the end of this year, and are unlikely to be fully operational until 2021-22.

Construction of Nord Stream 2, which is largely complete in Russian, Finnish, German and Swedish territorial waters, is being delayed by the Danish regulatory authorities. At the Danish energy agency's request, Nord Stream 2 AG last month submitted an application for a third alternative route through Denmark's exclusive economic zone, but condemned the request as "a deliberate attempt to delay the project's completion". The decision by Brussels on 15 April to extend the Third Gas Directive to pipelines starting outside the EU may also obstruct Nord Stream 2. In addition, the EUGAL pipeline from Germany to the Czech Republic, which will transport about half of Nord Stream 2's 55 bcm/year capacity, will not be complete until the end of 2020 at the earliest.¹

Construction of both strings of Turkish Stream offshore, and of the onshore continuation of the first string to Turkish destinations, is complete. But the continuation of the second string to Bulgaria, Serbia and Hungary will not be commissioned until 2021 at the earliest.²

Therefore, subject to assumptions about the level of demand in Europe for Russian gas, 50-90 bcm/year of Ukrainian transit capacity may be needed in 2020, but this will fall steeply by 2022. After that, assuming that Nord Stream 2 and Turkish Stream are operating at full capacity, the availability of a small residual level of Ukrainian transit capacity will probably be desirable for Gazprom, but may not be essential.³

The parties' positions

Russia: At the last session of the trilateral talks in Brussels on 21 January, the Russian delegation is reported to have (i) proposed that the current transit contract between Gazprom and Naftogaz be extended to the 2020s; (ii) proposed an end to the legal dispute between the companies (EC vice president Maros Sefcovic, who chaired the meeting, said the legal cases are "a huge stumbling block" for Russia; "it is difficult to negotiate a good contract for the long term when they are still fighting legal claims"); and (iii) called for an end to regulatory obstructions to the transit diversification pipelines.⁴

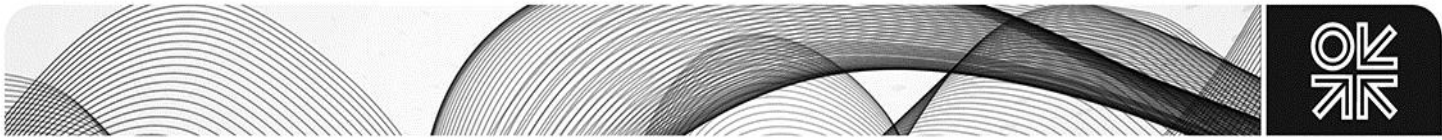
Ukraine: Naftogaz managers have proposed that Gazprom books 60 bcm/year of transit capacity for about ten years; that a further 30 bcm/year is made available for other shippers (e.g. European importers, or purchasers of central Asian or non-Gazprom Russian gas); and that payment be made by means of capacity booking and entry and exit tariffs, instead of the distance-based tariffs in the current

¹ "Russia's Nord Stream 2 gas link will be delayed 'years'", Platts, 11 April 2019; Nord Stream 2 AG press release, 15 April 2019; "Nord Stream 2 applies for third Danish route", *Argus FSU Energy*, 18 April 2019; "Nord Stream 2 threatens legal action", *Argus FSU Energy*, 25 April 2019; Gascade, EUGAL Facts and Background Information

² "Russia commits to Serbian route for TurkStream extension", *Interfax Natural Gas Daily*, 18 January 2019; "Gas deliveries to Hungary via Turkstream to begin late 2021", TASS News Agency, 22 March 2019

³ Projections of demand for transportation capacity are made, and associated issues discussed, in: Simon Pirani, *Russian gas transit through Ukraine after 2019: the options* (Oxford: OIES, November 2018)

⁴ "Russia, Ukraine to hold further gas talks in May", Reuters, 21 January 2019; "Gas talks in Brussels", UNIAN news agency, 23 January 2019



contract.⁵ Ukraine government and Naftogaz representatives also continue to insist that the unbundling of Naftogaz's transportation assets will be completed by the end of this year, when transportation services will be offered by a new corporate entity – but the unbundling process could potentially take much longer. Although this is not seen as a potential stumbling-block in negotiations with Gazprom, it may become a complicating factor at some stage.⁶

The EC: Vice president Sefcovic has said that the Commission's "top priority" is to ensure a long-term transit contract covering "at least ten years".⁷ There is no indication that Commission officials have at any stage proposed – in keeping with EU regulatory principles – auctions of Ukrainian capacity under the Capacity Allocation Management network code. This would lead to Ukraine organising an open season, with auctions of annual tranches of capacity for the next 15 years, which would establish the level of demand for capacity and allow a tariff to be set.

It is difficult to acknowledge the Russian proposal to extend the existing transit contract as a serious negotiating stance, since Gazprom is in the midst of arbitration proceedings aimed at annulling it. On the other hand, the Ukrainian and EC proposals for a large-volume, ten-year contract are difficult to reconcile with the known requirement for transit services, which in 2020 may well be at the levels referred to above, but subsequently will very likely fall sharply.

Suggestions from both sides to link negotiations on post-2020 transit to a resolution of the issues under arbitration also seem problematic. The arbitration institute of the Stockholm Chamber of Commerce has scheduled hearings for April-May 2021 on two cases to be heard together: Gazprom's application for annulment of the transit contract, and Naftogaz's claim for \$11.58 billion in unpaid transit fees. While Gazprom is calling for an unspecified means of ending all cases, Naftogaz executive director Yuri Vitrenko has said that much of the Naftogaz suit would be dropped if transit continues after 2020. But there are also unresolved issues related to the arbiters' order of February 2018 that Gazprom pay \$2.56 billion compensation to Naftogaz. Gazprom has not paid the compensation; Naftogaz has taken legal action in the UK, the Netherlands and some other jurisdictions to attempt to recover it; Gazprom has lodged an appeal against the award, due to be heard in Sweden in October this year.⁸ In short, the arbitral process is apparently completely stalemated at present.

While both Russia and Ukraine continue to stress that they believe a contractual agreement will be reached covering post-2020 transit – in October if not in May, in the view of Russian deputy energy minister Anatoly Yanovsky⁹ – they, together with some eastern European countries, are also preparing for an interruption of transit in January 2020. Measures taken include:

- Hungary agreed with Gazprom in March to buy and store its 2020 gas requirement during 2019. Possibly in response to this, Ukrtransgaz, the transport division of Naftogaz, announced that 12 bcm of its storage capacity will be made available "to meet potential threats to the energy security of EU countries", and a Ukrainian trader recently tested the export of small volumes to Hungary.¹⁰ (Hungary has in recent years imported 5.5-7 bcm/year of Russian gas, and has recently expanded its storage capacity to 6.3 bcm.)
- The Bulgarian energy minister Temenuzhka Petkova has stated that Gazprom Export has informed Bulgaria that it will cease transporting Russian gas via the Trans-Balkan route from Ukraine via Moldova, Romania and Bulgaria to Turkey from January 2020. Gazprom has denied this, although its spokesman acknowledged that with the commissioning of Turkstream, gas

⁵ "Ukraina na ozhidaemykh v mae peregovorakh predlozhit RF zabronirovat' 60 mlrd kub. m", Interfax-Ukraina, 25 April 2019

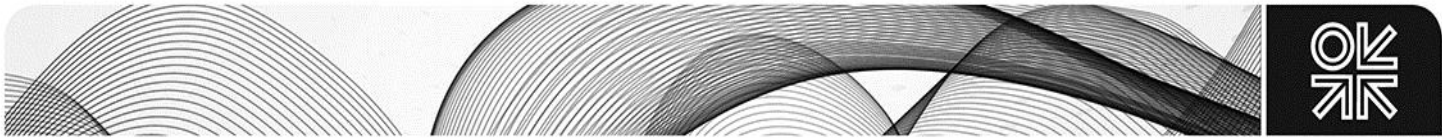
⁶ See Pirani, *Russian gas transit*, op. cit., pp. 17-18

⁷ "EK khochet provesti ocherednoi raund trekhstoronnikh peregovorov", Interfax-Ukraina, 9 April 2019

⁸ "Gas talks", UNIAN, op. cit.; "Dolga Gazproma pered Naftogazom", Interfax-Ukraina, 1 March 2019; S. Pirani, *After the Gazprom-Naftogaz arbitration: commerce still entangled in politics* (Oxford: OIES, March 2018); "Arbitrazh Stokgol'ma rassmotrit delo 'Gazproma' in 'Naftogaza' vesnoi 2021 goda", *Vedomosti*, 1 April 2019

⁹ "Minenergo RF ozhidaet, chto Moskva i Kiev dogovoriatsia", TASS, 25 March 2019

¹⁰ "Hungary to buy 2020 gas supplies early from Russia", Reuters, 21 March 2019; "Central Europe Market Commentary", *Argus European Natural Gas*, 25 April 2019; "Ukraina predlozhila sdat' v arendu ES tret' svoikh gazovykh khranilishch", *Vedomosti* 25 March 2019; "Ukraina nachala eksport gaza v napravlenii Vengrii", Interfax-Ukraina, 12 April 2019



would be supplied to customers “via a new system”.¹¹ In any case, Moldova, Romania and Bulgaria are among the most vulnerable countries if Ukraine transit is disrupted.

- Naftogaz has claimed that Gazprom is writing to customers warning them of possible disruption to transit.¹²
- Naftogaz plans to raise the volume of gas stored in Ukraine to at least 20 bcm by the start of the heating season in November 2019 (compared to 17.2 bcm in November 2018 and 16-20 bcm in the four preceding years). Executives have also said that technical staff are preparing to run the transportation system in reverse (i.e. west to east) if necessary.¹³

The level of these preparations indicates that companies and governments are far less than certain that a deal will be concluded.

Political factors

The main barriers to an agreement being reached on post-2020 transit are political rather than commercial. In Ukraine, the presidential election has ushered in some months, at least, of uncertainty; the initial reaction from Russia has been to heighten conflict.

Vladimir Zelensky, a comedian with no previous political experience, won the second round of the presidential election on 21 April with a landslide – 73%, against 25% for the incumbent, president Petr Poroshenko – that indicated deep ongoing discontent with the political class due to falling living standards (including the effect of higher energy prices), corruption, and the impact of military conflict.

The consensus among observers is that a competition for positions of influence in Zelensky’s administration may now ensue, between (i) western-oriented reformers, including former economy minister Aivarus Abromavicius and former finance minister Oleksandr Daniliuk who were in Zelensky’s pre-election team; (ii) other politicians; and (iii) oligarchical groups, in particular that of Igor Kolomoisky, who owns the TV channel for which Zelensky works.

Under Ukraine’s constitution, parliament has the key role in forming a government and appointing the prime minister; an incoming president can realistically only change the government by calling snap parliamentary elections; and Zelensky has not so far indicated that he will do so. (The constitution provides that the president may dissolve parliament at any time until 27 May; inauguration must be held by 3 June.) The president has the power to appoint the ministers of foreign affairs and defence, and the head of the national security council. But it is most likely that attention will now shift to the parliamentary elections in October, which will determine the make-up of the next government. Zelensky intends to form a political party to contest the election, but beyond that it is unclear what force or coalition of forces is likely to prevail.

The Russian government’s overt response to the election has been (i) to underline its support for politicians aligned with the pre-2014 Yanukovich government and (ii) to reassert support for the separatist forces that control parts of Donetsk and Luhansk regions in eastern Ukraine.

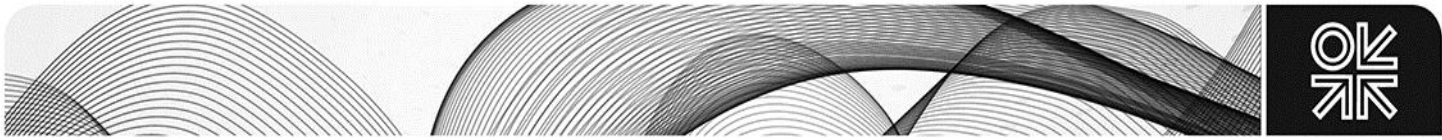
The support for politicians aligned with Yanukovich came prior to the first round of the presidential election. On 21 March Russian prime minister Dmitry Medvedev and Gazprom CEO Alexei Miller met with Yuri Boiko, Ukrainian presidential candidate from the opposition bloc that politically succeeded Yanukovich’s Party of Regions, and Viktor Medvedchuk, a political ally of his. The meeting participants went on television to propose the resuscitation of the 2002 Russo-Ukrainian consortium to manage the gas transportation system, and direct gas sales at a claimed 25% discount to final consumers.¹⁴

¹¹ “Bulgaria zaiavila ob otmene ‘Gazpromom’ tranzita”, Liga.net, 12 March 2019; “Gazprom will stop gas transit to Turkey from Ukraine by 2020”, Kozatka.media, 12 March 2019

¹² “V ‘Naftogaze’ zaiavili o planakh ‘Gazproma’ prekratit’ tranzit”, RIA Novosti, 20 March 2019

¹³ “Ukraina nachala sezon zakachki gaza”, Interfax-Ukraine, 8 April 2019; “Naftogaz working on possible reverse mode for Ukrainian GTS if Russia halts gas transit”, Interfax-Ukraine, 26 April 2019; Gas Infrastructure Europe web site

¹⁴ “Rossiia poobeshchala Ukraine skidki na gaz, esli Boiko stanet prezidentom”, *Vedomosti*, 22 March 2019



The reassertion of support for the separatist forces in Donetsk and Luhansk came, first, with the announcement on 18 April – three days before the second round of the presidential elections – of a new round of sanctions on Ukraine, starting on 1 June, including a ban on the export to Ukraine of crude oil and new restrictions on exports of oil products (most significantly, diesel oil) and on imports of Ukrainian machinery. This was interpreted by observers in Russia and Ukraine as a message to the incoming president of Russia’s tough stance on the military conflict.¹⁵

On 24 April, three days after Zelensky’s election, president Putin signed a decree simplifying the procedure by which citizens of the Donetsk and Luhansk “republics” can apply for Russian citizenship. Similar measures were applied to citizens of Abkhazia and South Ossetia, breakaway regions of Georgia, prior to the Russia-Georgia war of 2008. The measures were interpreted in both Kyiv and Moscow as a reassertion of Russian “aggression”.¹⁶ This is implicitly a step away from Russia’s position since 2014, of support for reintegration of the “republics” into Ukraine.

The conclusion from these events is not that Russian-Ukrainian relations will necessarily worsen further, or that a deal on gas transit is impossible, but that relations are unlikely to improve simply due to the Ukrainian presidential election result. Are there sufficiently strong motives to do a deal nonetheless? For Ukraine, the priority is surely to maximise transit revenue prior to the completion of diversification projects. For Russia, though, there may be a temptation to see the negotiations as part of a larger strategic battle with Europe over gas imports. Certainly this was the implication of the Russian proposals reported from the January talks, to tie an agreement to settlement of arbitration cases and resolution of regulatory obstacles to the diversification pipelines. These obstacles continue to be seen in Moscow, not without reason, as instruments used to reduce Gazprom’s market power for fundamentally political reasons.

If Russia pursues this approach, it cannot be excluded that a supply interruption in January 2020 could be seen by Russia as, if not desirable, at least useful for overcoming the EC’s perceived obstinacy. But in the broader scheme of things, with decarbonisation policies posing existential threats to some aspects of the gas business in Europe, this would be a high risk tactic that could backfire, by reinforcing arguments that other energy sources should be supported against gas.

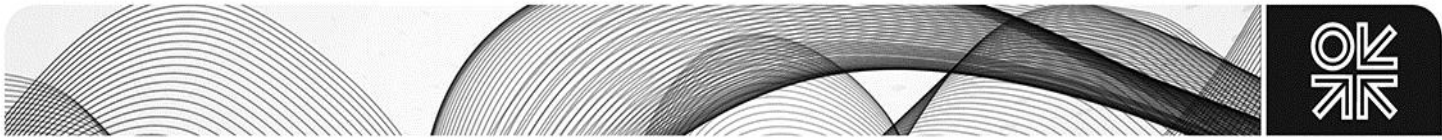
Scenarios for January 2020

From the above it follows that there are three possible scenarios for January 2020:

- 1) *An agreement is signed.* If all parties are intent on reaching an agreement, they may hope to do so before two significant deadlines: the Ukrainian parliamentary elections on 27 October, and the expiry of the EC’s term of office on 31 October. By the time a new Ukrainian government, and new EC officials, are at work, there will be little time for negotiation. In this author’s view, another significant step towards an agreement would be discussion of shorter-term, smaller-volume and more flexible arrangements than e.g. a ten-year contract covering 60 bcm of transit capacity.
- 2) *No agreement is signed, but Gazprom continues to pump volumes into the Ukrainian network for delivery to European destinations.* Ukraine would have clear obligations under the Energy Charter Treaty to deliver these volumes to exit points, and failure to do so would cause a supply interruption. One precedent for such a situation is the supply of gas by Gazprom into Georgian pipelines for delivery to Armenia. Between 1 January and 12 March this year, these deliveries

¹⁵ “Ukraina mozhete ostati’sia bez rossiiskogo benzina i diztopliva”, *Vedomosti*, 19 April 2019; “Moskovskie uroki energonezavisimosti”, *Zerkalo Nedeli*, 25 April 2019. Note that these measures were not connected either to the dispute on oil transit tariffs last month between Russia and Belarus, or to the brief suspension of transit via the Druzhba pipeline due to chemical quality issues

¹⁶ “Zachem Putin uprostit predostavlenie grazhdantsva zhiteliam DNR i LNR. Mnenie politologov”, *Vedomosti*, 24 April 2019; “Nachalo anneksii, udar po Zelenskomu ili poisk migrantov”, *Evropeiskaia Pravda*, 24 April 2019



continued in the absence of a transit contract: the previous agreement had expired and the new contract was still under negotiation.¹⁷ Observers in Moscow see this scenario as unlikely.

- 3) *No agreement is signed, and gas flows into the Ukrainian system stop.* The obvious route to a supply interruption would be a decision by Gazprom management. However it should be recalled that in the “gas war” of January 2009, this decision was not taken straightforwardly. With no supply or transit contract agreed, Gazprom suspended deliveries of gas for consumption in Ukraine, but continued to pump volumes for European customers; Naftogaz then deducted from these volumes fuel gas for pipeline compressor stations; Gazprom alleged that these volumes were stolen; supplies were drastically reduced, and then cut completely, amidst a complex public row about the whereabouts of volumes.¹⁸ It should further be recalled that once supplies had stopped in 2009, Ukrainian engineers reversed the pipeline system, to bring gas from storage located in western Ukraine to the largest consuming areas in the centre and east. This would be one likely consequence of any supply interruption in 2020.¹⁹

Conclusions

Whether or not agreement is reached by 31 December, there is no doubt that the large-scale transit of Russian gas via Ukraine to Europe is coming to an end. It is very likely that by 2022 both Nord Stream 2 and Turkish Stream will be operating at full capacity. There will be some requirement for residual transit via Ukraine, depending mainly on the level of demand for Russian pipeline gas in Europe, and seasonal factors.²⁰

The operating capacity of the Ukrainian pipeline system will have to be reduced; the southern Ukrainian pipeline corridor that traverses Moldova and meets the Trans Balkan line will best be operated in reverse, a fact recognised in Naftogaz’s investment plans. Ukrainian energy policy would benefit from a prompt recognition that the transit business needs to be downsized, and efforts focused on diversifying away from imported gas to domestic energy sources.

From a Russian policy standpoint, the incentive for reaching an agreement for post-2020 transit in good order is a matter not only of ensuring Gazprom’s ability to compete most effectively in the European market, but also, more broadly, of ensuring the place of gas in the European energy mix in the coming years. A supply interruption could serve as a significant blow to its acceptance.

¹⁷ “Gazprom prodliil tranzitnyi kontrakt s Gruziei”, *Kommersant*, 12 March 2019; “Contract between Georgia and Russia’s Gazprom on transit of natural gas in Armenia prolonged”, ARKA News Agency, 13 March 2019

¹⁸ Simon Pirani, Jonathan Stern and Katja Yafimava, *The Russo-Ukrainian gas dispute of January 2009: a comprehensive assessment* (Oxford: OIES, 2009), pp. 19-22

¹⁹ The possible effects of a supply interruption are discussed in detail in: Pirani, *Russian gas transit*, op. cit., pp. 8-11

²⁰ For detail see Pirani, *Russian gas transit*, op. cit., pp. 11-16