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Gas negotiations Ukraine-Russia-EU: war of attrition

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After a break of more than three months, and intensive efforts by the EU, trilateral gas talks between Ukraine, Russia and the EU were resumed on 26 September. At a meeting in Berlin, the EU's energy commissioner Günther Oettinger proposed a temporary solution to the Russian-Ukrainian gas dispute, the adoption of which would enable a stable supply of natural gas during the winter to both Ukraine and the EU. The fundamental differences between the parties led to the failure of the gas negotiations in June, which resulted in the suspension on 16 June of Gazprom's gas supplies to Ukraine. The new EC proposal is unspecific on many points (such as the method of calculating the Ukrainian debt to Gazprom; the bases of the new supply, including the price formula; and the 'take or pay' clause) and will require further difficult negotiations.

Kyiv, whose energy situation is becoming increasingly difficult, is willing to enter into a temporary compromise, but under the condition that the final size of its debt is not prejudged, and that during this period a constant gas price no higher than US$385 per 1000 m³ is guaranteed. Russia's position shows that its efforts are continuing to force Ukraine into accepting temporary solution which favour Russian interests; that would mean a *de facto* continuation of the existing mechanisms for gas cooperation. Moscow has not shown any will to make a real compromise, but is instead blackmailing European customers with interruptions to their gas supplies during winter. It is thus hoping that the EU will accede to Russia's position, which will put additional pressure on Ukraine to adopt the Russian ultimatum. As a result, the parties' divergent positions significantly reduce the opportunity for a real compromise.

The EU's proposals and interests

According to the EC's proposals presented in Berlin, Ukraine would pay off its debts for unpaid gas supplies from Russia at a temporary price of US$268.50 per 1000m³, in two tranches: US$2 billion would be paid by the end of October, and the remaining US$1.1 billion by the end of this year. Gazprom and Naftogaz would furthermore agree to supply at least 5 bcm of gas at a price of US$385 per 1000 m³, with the option to order additional volumes. The details of this proposal will be subject to further trilateral talks, so that an interim agreement binding all the parties can be reached, which will allow them to proceed while awaiting the completion of arbitration proceedings in the cases brought by Russia and Ukraine. In proposing this compromise solution, the EU wants to limit the risk of interruptions to the transit of Russian gas through Ukrainian territory during the winter. At the same time, bringing about at least a temporary suspension of the gas dispute would be

an important success for the outgoing commissioner Oettinger.

Kyiv's goal: a temporary compromise

Although Kyiv has emphasised for several months that its goal is to bring about a comprehensive review of the Russian-Ukrainian gas contract (including a significant reduction in prices, and a revision of the 'take or pay' clause), it is willing to agree to a temporary compromise, albeit under certain conditions. Ukraine is ready to repay part of its debt, but only if this does not affect adversely its position before the arbitration decision in Stockholm (mainly in relation to the calculation of the debt). In addition, the Ukrainian side is applying for a consistent formula for gas prices during the period of the agreement's provisional application. At the same time, Kyiv is hoping for a positive outcome from the Stockholm Arbitration Tribunal, which would force Gazprom to make the revision to the gas contract which Ukraine has proposed. However, considering the specificity of international commercial arbitration on the one hand, and the complexity of the dispute between Gazprom and Naftogaz on the other, the tribunal will probably make its final decision only after many months.

In recent months, Kyiv has taken measures to increase the supply of gas from the west; for example, in September it managed to open reverse gas flow from Slovakia (via the Vojany-Uzhgorod gas pipeline), and sign agreements with several Western companies for supplies via that route, including a contract with Statoil (up to 15 million m³ of gas per day, starting from 1 October). Despite the reverse gas supplies, Kyiv's accumulation of 16.7 bcm of gas in storage facilities (as of 6 October) and the adoption of drastic austerity measures for gas (supplies have been cut by 20% for residents and 30% for industry), Ukraine can only manage to endure without Russian gas until March or April 2015. The energy situation has been worsened by the problems Ukrainian power plants have been having with coal supplies, as over 70% of the mines in the Donetsk basin have been forced to suspend production, or have been destroyed. In turn, those which are still functioning cannot send coal to other regions, due to damage to the rail infrastructure. As a result, the carbon deficit is running at 1 million tonnes per month, increasing domestic demand for gas. In order to fully balance its energy needs during the winter, including the transit of Russian gas to the EU, Kyiv needs additional supplies of about 5 bcm of gas from Russia.

Russia's position remains unchanged

The outcome of the meeting in Berlin shows that the Russian negotiating position as presented during the gas talks in May and June has not fundamentally changed. Russia has consistently called for Ukraine to repay at least part of the debt for gas supplied in November-December 2013 and April-June 2014 (according to Gazprom, the total debt is US$5.3 billion), making the resumption of supplies dependent on this. Gazprom has declared that if Ukraine repays around US$3.1 billion (c. US$2 billion by the end of October, and US$1.1 billion by the end of December), it would be ready to supply Ukraine in time for the upcoming heating season – within a prepayment regime, and under the 'take or pay' clause – with at least 5 bcm of gas. Russia is ready to grant Ukraine a discount on new gas supplies by a governmental decision to reduce the export duty by US$100, so that the final

price will be c. US$385 per 1000 m³.

The Russian position indicates that Moscow's primary objective is to maintain the existing mechanisms for keeping Ukraine dependent on its gas, as it consistently refuses to enter into negotiations on a proposed revision of the gas contract with Kyiv dating from 2009. Moscow will also undermine Ukraine's attempts to change the bases of the two states' gas cooperation by bringing a case to the arbitral tribunal in Stockholm. Reports by the Russian daily *Kommersant* indicate that during the talks, Gazprom turned to the Ukrainian side with a request to withdraw the petition submitted to arbitration. On the other hand, in the face of Kyiv's expected determination, Gazprom will seek to undermine the Ukrainian position during the arbitration proceedings. This is illustrated by Gazprom's assertion that the debt for gas supplied in November-December 2013 and April-June 2014 (which according to Russian calculations amounts to around 11.5 bcm) is US$5.3 billion. Moscow is trying to use this to force Kyiv to accept delivery prices of around US$460 per 1000 m³, which differs significantly from Naftogaz's price demands (a figure within a range of US$268.50-385 per 1,000 m³ is considered acceptable).

Russia blackmails the EU

In order to compel Ukraine to accept Russian conditions for an interim agreement, Russia is trying to exert political and economic pressure on the EU and its member states. By emphasising that the Russian and EU positions are moving closer (both parties agree that Ukraine must repay the debt for the Russian gas), Moscow is putting pressure on Brussels, scaring it with the potential negative consequences of a failure to reach agreement on the gas question. According to Gazprom, meeting Russia's commitments to export to European customers in the winter means that the Ukrainian gas storage facilities must be kept filled to appropriate levels. Russia's tool for applying economic pressure is supplying gas to certain European customers at lower levels than the orders placed by importers (in particular, the Slovak Republic, and to a lesser extent Poland, which continue to allow reverse gas supplies to Ukraine), as well as lower than expected supplies to countries such as Italy and Austria. The Russian determination to sabotage the reverse gas flows from Europe to Ukraine is demonstrated by the statement from the Russian energy minister ("uninterrupted supply of gas to Europe can only be guarantee if the recipients honour the contracts they have concluded with Russia, which do not provide for the re-export of the gas"), as well as by reports that the Russian State Duma is working on a law prohibiting the export of energy resources to countries with energy debts to Russia, and to countries which re-export Russian gas to third countries which have financial debts to Russia.

Little chance of agreement

The next round of gas negotiations will probably take place in mid-October, but – because of the fundamental differences in the parties' interests and expectations – the chances of working out a compromise solution are slim. The European Commission's proposal for a provisional agreement does not address itself to many of the key points of contention between the parties (see the Appendix). In addition, the EC has not considered the very difficult financial situation of Ukraine, which means it is not clear how Kyiv would repay the

its debts or pay for new deliveries. Kyiv's position will also be made less flexible as a result of the parliamentary elections scheduled for 26 October. At the same time, the end of the current European Commission's term hinders its effective involvement in devising a difficult compromise. In turn, Gazprom is aware that time is on its side, and that the pressure it is applying on Brussels and some of the recipient countries of Russian gas is beginning to have the desired effect.

In the coming months, as the gas in Ukrainian storages depletes, Kyiv's negotiating position will weaken, which may persuade it to make concessions, even more so as pressure from Brussels on Ukraine to come to an agreement with Gazprom is likely to increase. It is also conceivable that Russia could provoke interruptions in gas supplies to the EU during the winter, while accusing Kyiv of *siphoning off*its gas shipped through transit pipeline to EU customers.

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Appendix

The reported proposals by the EU, Ukraine and Russia during gas negotiations

	The EU's position	Russia's position	Ukraine's position
Debt	Debt repayment by Ukraine of US$3.1 billion at an interim price of US$268.5 per 1000 m³, in two instalments: - US$2 billion by the end of October - US$1.1 billion to the end of 2014 After the arbitration ends, additional payment by Ukraine (if the court finds that the supply prices from November-December 2013 and April-June 2014 are higher), or recognition that all the debt has been settled (if the tribunal considers the temporary price to be final)	Ukraine repays US$3.1 billion as part of the debt (Russia calculates the total debt at US$5.3 billion) in two instalments: - US$2 billion by the end of October - US$1.1 billion to the end of 2014 Considering the Russian data, that in November-December 2013 and April-June 2014 c. 11.5 bcm of gas was delivered to Ukraine, the final gas price at the settling of the debt would amount to c. US$460 USD per 1000 m³	First, payment of US$1.9 billion as prepayment for new gas supplies from Russia After Gazprom resumes deliveries, US$3.1 billion of debt is repaid in three instalments: - US$1.5 billion by the end of October; - US$800 million in November; - US$800 million in December.

Price for new gas supplies	US$385 per 1000 m³ (for 6 months) No details given concerning the mechanisms and rules for determining the price, principles for payment (prepayment or not), or the schedule of deliveries	US$385 per 1000 m³ (for 6 months) Price obtained by applying the existing pricing formula, with an export duty discount of US$100	US$385 per 1000 m³ (for 6 months) Price fixed by modifying the pricing formula in the annex to the 2009 contract. Demand to establish a detailed schedule for supplies and the principles of paying the fees.