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Irritation at the Kremlin following the gas arbitration

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On 2nd March the CEO of Gazprom CEO, Alexei Miller, announced that two gas agreements with the Ukrainian company Naftogaz would be terminated: the contract for gas supplies and the contract for the transit of Russian gas through Ukraine. Kyiv confirmed that Ukraine had received related documents from Gazprom. The previous day Russia refused to renew gas supplies to Ukraine and returned the pre-payment received from Naftogaz. The official justification it gave for this decision was the lack of a new addendum to the contract for gas supplies. Furthermore, that same day Kyiv announced that Gazprom had lowered the level of pressure in Ukrainian gas pipelines (used to export Russian gas to Europe) by 20%.

Commentary

- The measures undertaken by Russia should above all be seen as a certain political manifestation in reaction to Gazprom's defeat in the legal dispute against Naftogaz. It is rather likely that the decision announced by Alexei Miller was in fact made at the Kremlin. It stems from the particular character of the Russian system wherein Gazprom is a state-controlled company and Vladimir Putin makes all the strategic decisions concerning it. The decision which he made to halt the construction project of the South Stream gas pipeline and to replace it with the Turkish Stream project is an example of this type of action.
- The short-term implications of activating the procedure of terminating the contracts are infinitesimal. Firstly, the contracts do not allow for a unilateral termination of them as this would require consent from Naftogaz, which the Ukrainian company has firmly ruled out. The opening of the procedure does not thus have any impact on the legal status of the contracts; both parties are obliged to respect its provisions, including the ruling of the Arbitration Institute of the Stockholm Chamber of Commerce (henceforth: the Arbitral Tribunal) regarding the contract for gas supplies (22nd December 2017) and the ruling regarding the transit contract. Secondly, should it prove impossible to terminate the contract by mutual agreement, the final decision regarding Gazprom's claims will be made by the Arbitral Tribunal (the Russian company has already submitted the related documents there). However, the legal proceedings could potentially last several months or longer and it cannot be ruled out that it will not end before the Russian-Ukrainian gas contracts expire (until 31st December 2019). Thirdly, the chances of the Russian claims being taken into consideration in the new arbitration are slim given the fact that the arguments Gazprom has advanced are in fact a political assessment of the motivation

guided – so Russia believes – the arbiters. The Russian company has accused the Arbitral Tribunal of 'a lack of balance in taking the interests of the parties into account', using double standards and attempts to solve Ukraine's economic problems at Gazprom's expense.

- There are many indications that the main purpose of the measures undertaken by Russia is to provoke a gas crisis which would discredit Ukraine as a transit country. It is one of the elements Moscow employs in its strategy towards Kyiv in order to justify the need to build transit routes (Nord Stream 2, Turkish Stream) which would provide an alternative to the Ukrainian ones. The fact that Gazprom has been found guilty of infringing on the transit contract deprives Moscow of the arguments it has been using to continue challenging Ukraine's credibility. It is therefore likely that Moscow will seize any opportunity to provoke Ukraine to undertake measures which will allow the Kremlin to continue pointing to Ukraine as the main source of the continual problems in EU-Russian gas relations. Should Gazprom delay the payment of damages (US$ 2.56 billion) awarded to Naftogaz by the Stockholm arbitration court, it may prompt Kyiv to begin the procedure of recovering the arrears from Gazprom assets in Europe or by seizing Russian transit gas as a means of satisfying Ukrainian claims (the deputy CEO of Naftogaz, Yuriy Vitrenko has not ruled out this option).
- It should be expected that Gazprom will continue sending its gas through the routes bypassing Ukraine (Nord Stream 1, Yamal–Europe, Blue Stream pipelines) and will not increase the volume of the gas sent via the Ukrainian route to the contracted 110 bcm a year – this commitment has been confirmed in the award issued by the Arbitral Tribunal. This means that if Gazprom ignores the arbiters' ruling, it will generate additional claims from Naftogaz as well as issues in bilateral contacts and relations between Russia, Ukraine and the EU. However, a halt or reduction in Gazprom's gas supplies to its EU recipients seems rather unlikely in the immediate future.
- Irrespective of the resolution of the dispute regarding the Russian-Ukrainian gas contracts in force, it is the most likely that Gazprom will be forced to sign a new transit agreement with Ukraine for supplies of Russian gas after 2020, particularly if Russian transit remains at the present level (84 bcm in 2016, 94.3 bcm in 2017). The present transit contract expires at the end of 2019 and Gazprom does not have alternative routes which would enable it to decrease the volume of gas sent through Ukraine. At present, only Turkish Stream is under construction as an alternative route to the Ukrainian ones (as of 5th March, 50% of the marine section of both branches of the pipeline has been constructed). The opening of the first branch of the pipeline in 2019 will allow Gazprom to redirect merely 15 bcm a year from the Ukrainian route. Thus Gazprom may be compelled to supply as much as 70–80 bcm of gas via Ukraine in 2020, assuming that the transit volumes from 2016-2017 are to be maintained.