

Temporary stabilisation: Russia-Ukraine gas transit deal

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A five-year contract concerning Russian gas transit via Ukraine was signed after four days of negotiations on 30 December 2019. The previous contract expired on 1 January 2020. The EU-brokered talks between Moscow and Kyiv preceding the deal lasted many months and ended in the signing of a political protocol on 20 December which defined the terms of a package agreement. Gazprom has been obliged under the new transit contract to transport 65 bcm of gas in the first year and 40 bcm in the next years based on the ship-or-pay formula. Four other documents were also signed: (1) an agreement between Naftogaz and Gazprom waiving counterclaims linked to the gas contracts of 2009; (2) an interconnection agreement between Gazprom and a company named Operator of the Gas Transmission System of Ukraine (OGTSU); (3) a settlement between Gazprom and the Ministry of Justice of Ukraine; (4) a transport agreement between Naftogaz and OGTSU. The Russian company had to pay US\$2.92 billion in damages under the Stockholm Arbitration Court's ruling before the documents could be signed; it did this on 27 December.

Although the exact wording of the agreements has not been revealed to the general public, their key provisions are known because they were included in the protocol signed on 20 December. Both parties have recognised the gas package deal as a compromise, while most of its provisions can be viewed as a success for Ukraine. Gazprom had to make concessions because it was Moscow which most needed a new transit agreement; without one it would not have been able to meet its contractual obligations with regard to European clients. The European Commission-mediated talks were long and tough, due to the fundamentally different interests of the two parties. Ukraine wants to maintain its status of a major transit state, while Russia has been making consistent efforts to rely less and less on Ukrainian gas pipelines, such as pushing through the construction of Nord Stream 2 and the finalisation of the TurkStream project in 2018. Obstacles to compromise included: a *de facto* military conflict between the two countries, legal disputes between Naftogaz and Gazprom, the ongoing reform of the Ukrainian gas sector and the presidential and parliamentary elections in Ukraine. The compromise will entail a new model of transit co-operation between the parties, which should ensure stability in this area until 2024. It is also possible that a contract covering direct supplies of Russian gas to Ukraine will be signed in the near future, since they were stopped in November 2015.



The expectedly long negotiations and their context

The deal is an effect of arduous negotiations which lasted for almost one and a half years. The talks were conducted predominantly in the trilateral format (Russia–Ukraine–European Union) as part of which meetings were held on political and technical levels. Several bilateral meetings were held in the final phase of the negotiations between representatives of the Russian and Ukrainian sides. Germany was also engaged in the negotiation process – Berlin was the venue of two out of the five trilateral rounds of the talks. Furthermore, the German government appointed a special plenipotentiary for Russian gas transit via Ukraine in August 2019. These issues were also consulted on a regular basis over the phone by Chancellor Angela Merkel and President Vladimir Putin. The negotiation process was streamlined in the final phase primarily owing to the 9 December Paris meeting of the Ukrainian, Russian, French and German leaders as part of the Normandy Format talks devoted to resolving the Donbas conflict.

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It was expected that the negotiation process would be long due to the rapidly changing political situation.¹ On the one hand, the deadlock was an effect of the political calendar in Ukraine (the presidential elections were held in April and the parliamentary elections in July), and the Russian side made it clear on several occasions that any arrangements concerning gas issues could only be made after the election cycle was over. Another major factor was the progress in the implementation of Russian pipeline projects, which are being constructed in order to reduce Russia’s dependence on the Ukrainian transit route. TurkStream was completed in November 2018 (two branches with a total capacity of 31.5 bcm); and the construction of

Nord Stream 2 was launched in September 2018 and was continued at breakneck speed in 2019 (according to Gazprom’s data, over 93% of it has been laid so far). Finally, the US sanctions affecting the firms engaged in the construction of Nord Stream 2 (approved by President Donald Trump on 20 December) provided an important context for the final stage of the negotiations, which led to the construction work being stopped. However, it is difficult to determine the impact they had on the finalisation of the Russian-Ukrainian gas negotiations.

Additionally, both Ukraine and the European recipients of Russian gas, fearing a possible gas crisis should a new transit contract not be signed, increased the level of reserves in gas storages. Kyiv, preparing for the worst-case scenario, secured record-high gas reserves (almost 22 bcm). Even if imports westwards were discontinued, this would guarantee a safe heating season. Furthermore, the Ukrainian government and representatives of Naftogaz declared on numerous occasions that, were Gazprom not to agree to sign a new contract, Ukraine would begin treating the gas shipped via its territory as contraband and would stream it to its own gas tanks. European recipients also prepared for a potential gas crisis, proof of which is that their gas storages are 95–100% full.

What is the deal?

The agreements signed by the parties provide for the resolution of the key points of dispute concerning Russian-Ukrainian gas co-operation.

Firstly, Naftogaz and Gazprom signed a five-year contract concerning Russian gas transit via Ukrainian territory. The following transit volumes are envisaged under the contract: 65 bcm in 2020, and 40 bcm of gas annually in the next four years. As announced by the Ukrainian side, supplies will be based on the ship-or-pay formula (this formula imposes the obligation on Gazprom to pay for the transit of the contracted volumes of gas regardless of the actual transport volumes). In addition to this, the protocol of 20 December envisages the possibility of renewing the transit contract for

¹ See more: S. Kardaś, A. Łoskot-Strachota, S. Matuszak, ‘A ‘last-minute’ transit contract? Russia-Ukraine-EU gas talks’, *OSW Commentary*, no. 291, 25 January 2019, www.osw.waw.pl.

a further ten years (2025–2034). At the same time, Gazprom signed an interconnection agreement with OGTSU. In turn, OGTSU signed the same kind of agreement with the Slovak, Polish, Hungarian and Romanian operators.

Secondly, Gazprom repaid the US\$2.92 billion debt to Naftogaz as ruled in the final arbitration awards passed in December 2017 (concerning the Russian-Ukrainian supply contract) and in February 2018 (concerning the transit contract) by the Stockholm Arbitration Court. Furthermore, both Naftogaz and Gazprom are obliged to withdraw from the new arbitration proceedings launched in 2018–2019 – this, in particular, concerns the Ukrainian claim of July 2018 for damages worth around US\$12.3 billion for potential losses in case Gazprom discontinued gas transit via Ukraine due to the planned launch of alternative transport routes. Gazprom, in turn, withdrew its appeals against the final arbitration awards. Kyiv also decided to withdraw its claims resulting from the decision of the national anti-trust agency which in January 2016 imposed on Gazprom a fine of around US\$7.3 billion for abusing its dominant position on the Ukrainian market. As part of the deal, Naftogaz also agreed to refrain from continuing enforcement proceedings against Gazprom's assets in Switzerland, Luxembourg, the Netherlands and the United Kingdom.

What is not clear is the transit tariff (in 2019, Gazprom used to pay US\$2.61 for transporting 1,000 cm of gas per 100 km-long section). According to the provisions of the protocol of 20 December, the tariff is to be competitive and correspond to the rates that apply in Central and Western Europe. The Russian side on numerous occasions pointed out during the negotiations that in order to continue transit via Ukraine, it must be cost-effective to Gazprom, i.e. cheaper than transport using alternative routes. Furthermore, it can be concluded from statements made by the directors of Naftogaz that a higher tariff will be applied to potential additional volumes (above the guaranteed minimum), and the tariff has not been precisely determined.

Consequences for Ukraine

The Ukrainian side has managed to obtain a guarantee that it will retain almost half of the present volume of Russian gas via its territory until 2024. Although this needs to be viewed as a success, transit incomes will inevitably fall to a significant degree (according to information from Ukrainian sources, they will reach a total of at least US\$7.2 billion within the next five years). One of Ukraine's key goals was to retain the highest volume possible of Russian gas transports to the West (in 2018 it was 86.8 bcm, and in 2019 it was 89.6 bcm) for as long as possible because so far this has generated income of around US\$3 billion annually. In this spirit, the European Commission's put forward its initial proposal in January 2019 envisaging the signing of a 10-year transit contract, with a transit volume of at least 60 bcm annually.

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However, following the launch of both branches of TurkStream and Nord Stream 2 at the end of 2020) if Gazprom was able to use the new gas pipelines at full capacity, and demand for Russian gas remained at the present level, gas transport volumes might have been reduced to almost zero without a new transit contract. Thus the recently signed contract will extend the use of the system of transit gas pipelines for at least five years, with a guaranteed transport volume of 40 bcm, i.e. the minimum quality necessary to maintain the system's profitability, according to Ukrainian calculations. At the same time, the deal does not guarantee that Gazprom will still transport gas via Ukrainian gas pipelines after 2024. Discontinuation of Russian gas transport would make it necessary to turn off a significant section of the system. It is important that the agreed conditions give Ukraine time to prepare for this and to adjust the size of the transport system to its own domestic needs.

A further success for Ukraine is the fact that the arbitration court ruled that Gazprom must pay US\$2.9 billion in damages; this is of major signif-

icance for the Ukrainian budget. Since the beginning, Ukraine has consistently rejected the Russian demands to withdraw from enforcing the debt and has only accepted the option of withdrawing the new suits which were brought to arbitration in July 2018.

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Negotiations with Gazprom took place alongside the complex process of Naftogaz’s unbundling, which was an important part of the gas sector’s reform and a necessary condition to enable the signing of a new contract with Gazprom in compliance with the EU rules. The Unbundling Act was passed by Ukraine’s parliament as late as 31 October and signed by President Volodymyr Zelensky on 15 November. In effect, a gas pipeline system was separated from Naftogaz and licences to operate the pipelines were granted for 15 years to OGTSU (a company 100% owned by Ukrtransgaz, a subsidiary of Naftogaz). Then, shares in OGTSU were handed over to the state-controlled company Mahistralni Gazoprovody Ukrayiny (MGU). The unbundling is in compliance with the principles of the so-called EU Third Energy Package. OGTSU was certified by the Energy Community on 17 December, which was confirmed by the European Commission on 27 December. The main effect of the unbundling is the fact that OGTSU assumed the responsibility for Russian gas transit starting from 1 January 2020.

Two Ukrainian companies, Naftogaz and OGTSU, are mentioned in the new co-operation terms set after negotiations with Gazprom. For a start, the Russian company will sign a contract with Naftogaz as a ‘gas transport organiser’ which will reserve transport capacity in the gas pipeline system with OGTSU. Direct transit functions will be performed by OGTSU, which will also sign a contract with Gazprom. The Russian side will pay the transit charges to Naftogaz on the basis of the previously agreed tariff. In turn, Naftogaz

will settle accounts with the operator. It is unclear how this model will work in practice. Based on Russian statements, it was Gazprom who insisted on creating the model so that Naftogaz, which in essence became a dealer, took over the risks linked to the operation of Ukraine’s gas system once the unbundling was over. However, the new model seems to be beneficial also for Naftogaz, which will retain part of the profits generated by transit; to date these have accounted for almost half of its total income.

The last point of the protocol of 20 December provides for the option of signing a contract covering direct Russian gas supplies to Ukrainian recipients. This was Gazprom’s major goal from the beginning of the negotiations. At the same time, the Ukrainian government did not rule this out, expecting to be offered lower prices than it pays for gas supplied from the West. This is important from Kyiv’s viewpoint given the possibility of softening the blow of the gas price rise which will result from the liberalisation of gas prices for individual users and the public sector starting from 1 May 2020.

Russian concessions and benefits

The terms of the deal reveal that it was the Russian side who had to make more concessions in the final phase of the negotiations. Even though Moscow adopted increasingly tougher rhetoric throughout the talks and did not show a readiness to give up its demands, its negotiation position was in fact weaker. The absence of a transit contract with Ukraine would have prevented Gazprom from fulfilling its contractual obligations to numerous European recipients of Russian gas. In turn, this would have entailed not only serious reputational but also economic losses.

Firstly, Moscow has in fact recognised that Gazprom owes an arbitration debt to Naftogaz even though representatives of the Russian side emphasised on numerous occasions in the earlier stages of the negotiations that Ukraine had to withdraw its arbitration claims or Russia would not agree to sign a new transit contract. This was

the official stance in the last public version of the terms of a new agreement published by Gazprom on 25 November 2019. Secondly, Moscow insisted that in order for a new transit deal to be struck, it had to be accompanied by the signing of a new contract covering direct Russian gas supplies to Ukraine. This condition was put forward for the first time during the trilateral gas talks that were underway in January 2019. The signed protocol does not provide for any obligations to this effect—only the possibility of signing such a contract is envisaged, if the parties are interested. Thirdly, the basic parameters of the new transit deal differ from those proposed earlier by the Russian side. During the last phase of the negotiations, Gazprom proposed renewing the current transit contract or signing a new one for only one year. As regards the volumes, Gazprom’s representatives suggested in April 2018 that it was possible to sign an agreement imposing the obligation to transport 10–15 bcm of gas.

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However, the contracts also include solutions that are beneficial for Moscow. The agreed minimum Russian gas transit volumes are not a burden for Gazprom, although including the ship-or-pay clause in the contract is a certain concession (the protocol of 20 December did not provide for this). The Russian company would have to use the Ukrainian transport network for the next few years anyway to fulfil its contractual obligations with regard to European recipients. Launching the TurkStream gas pipeline in January 2020 allowed Gazprom to redirect relatively small quantities of gas currently transported via the Ukrainian route to Turkey, Greece, Bulgaria and North Macedonia. However, it is unclear when the Russian company will be able to use the second branch of TurkStream to its full extent. The time of the launch

and the scale of supplies via the Nord Stream 2 pipeline are also unknown. The finalisation of this project may be delayed due to the US sanctions. Moreover, even once the pipeline is put into operation, the scope of its commercial use will be limited due to the restrictions imposed by the amendment of the Gas Directive adopted in April 2019. On top of that, the judgement passed by the General Court of the European Union in September 2019 annulling the European Commission’s decision concerning the OPAL gas pipeline forced the Russian company to reduce the volume of gas transport via Nord Stream 1 (the decision of 2016 envisaged exclusions of certain rules of the so-called Third Energy Package, thus enabling Gazprom to use Nord Stream 1 at full capacity). Nevertheless, the absence of the obligation to renew the contract after 2024 allows Gazprom to remain flexible in developing its medium- and long-term trade policy. Regardless of its present problems, the Russian company will finalise the Nord Stream 2 project within a five-year time-frame. Most likely, infrastructure enabling the use of the second branch of TurkStream at full capacity will also be ready in European countries.

What next?

Although the protocol of 20 December was a political document which did not impose any legal obligations, both parties have manifested their will to implement its provisions – the package of agreements signed are proof of this (only one day late according to the schedule included in the protocol). Everything appears to indicate that the new gas co-operation model will function to the end of 2024. If demand for Russian gas in Europe remains on the present level, transit volumes via Ukraine may be even higher in the coming years than envisaged in the contract because it is unclear whether Gazprom will be able to use the alternative transport routes at full capacity. Even though the Russian plans to stop using Ukrainian gas transit routes have been postponed for five years, it is uncertain whether Ukraine will retain its significance as a transit country after 2024.