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RUSSIA-UKRAINE TRANSIT DEAL: A Crisis Postponed?

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The last minute signing of the transit contract between Russia and Ukraine has led to a fall in European gas prices as markets reacted to news of the deal.

The deal took place in the context of reforms in the Ukrainian energy sector which saw the unbundling of Naftogaz and the certification of the new transmission system operator by the Ukrainian authorities.

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The strategic objectives of the Russian Federation to end transit across Ukraine, to isolate Kyiv from its EU neighbours, restore gas dependence and restore Russian influence remain in place.

To counter such threats Ukraine and its allies should consider a number of steps. The first is for the EU and the US to assist in funding interconnectors between Poland and Ukraine and expanding storage capacity in Ukraine.

Very late on December 30th 2019 Gazprom signed off on a series of documents that provided the basis for continuing gas transit across Ukraine. This deal was very late in all senses, very late at night around 11pm Moscow time, and late in the day as the existing Russian-Ukrainian gas transit deal was set to expire at 10am Moscow time on 1st January. The immediate effect of the signing of a new transit deal until the end of 2024 was to provide supply certainty to gas consumers and traders. The signing of the transit contract has also led to a fall in European gas prices as markets reacted to news of the deal. Falling prices were also affected by traders' knowledge that significant amounts of gas had been placed in storage across the continent in anticipation of a supply crisis creating greater liquidity and pushing prices lower into early 2020. The deal also took place in the context of reforms in the Ukrainian energy sector which saw the unbundling of Naftogaz and the certification of the new transmission system operator by the Ukrainian authorities in accordance with EU law principles. Henceforth, the Ukrainian transit system would operate by a much more certain and transparent rule-based system.

Notwithstanding these positive developments, the strategic objectives of the Russian Federation to end transit across Ukraine, to isolate Kyiv from its EU neighbours, restore gas dependence and restore Russian influence remain in place. The principal reason for the willingness of the Russian Federation to authorise Gazprom to do deal with Naftogaz was that on December 20th in the National Defence Authorisation Act (NDAA), the US had placed effective sanctions on the Nord Stream 2 pipeline. It may now take Gazprom between two and five years to get the pipeline completed, authorised and running. For Ukraine the deal essentially amounts to providing Kyiv with a breathing space. Kyiv now has to raise its domestic gas production, fully physically, commercially and legally integrate its gas market into the EU gas market. Such integration will provide Ukraine with additional energy security as well as commercial opportunities. If it fails to do so, then Moscow's strategic objectives are much more likely to be ultimately achieved and in the process, triggering a greater crisis than would have been triggered that in respect of the expiry of the Russian-Ukrainian transit contract in January 2020.

The deal as it stands clearly has significant positive value for Ukraine.

Preparing for the Worst

From the end of the last winter heating season in March/April 2019, the prospect of the expiry of the 2010 Russian-Ukrainian transit contract on 1st January 2020 became a major source of concern for gas suppliers and traders across Europe. Following the gas crisis of 2009, the EU had supported a range of measures from mandating reverse flow obligations for all new pipelines, through the building of new interconnectors to developing alternative sources of supply[1]. However, a sustained gas crisis would still result in a surge of gas prices, and if it lasted any length of time, over a greater period than the two-week period that the 2009 crisis lasted, it would begin to result in actual shortages as well as price increases. As a consequence, from spring 2019 across the continent gas storage stock levels were raised. By November 2019 gas storage levels were at historic highs of the 19 EU countries that reported to the European Aggregated Gas Storage Inventory; all but one (Latvia) were 95% full[2]. In Ukraine, Naftogaz had a total of 18bcm in storage equivalent to 15 months of imports. The energy markets also understood that the trilateral discussions between Ukraine, Naftogaz and the European Commission to close a new transit deal, which had been running since July 2018 were not going well. In September the Commission supported proposal for a new 10-year transit contract with a minimum transit requirement of 60bcm had been rejected by Gazprom. Furthermore, Gazprom had made a precondition of any new contract that Naftogaz had to waive the award of $2.56 billion it had received from the Stockholm Court of Arbitration in its February 2018 victory over the Russian gas company.

1. For instance, the key role of the Security of Supply Regulation 2017/1938, OJ L280/1 28th October 2017 and its predecessor which mandated reverse flow capacity on critical pipeline infrastructure. In addition, the EU Connecting Europe Facility has a fund of €4.7 billion for energy interconnector projects for the period 2014-2021.
2. Mitrova et al, Russia-Ukraine Gas Transit Talks: Risks for All Sides, OIES, Oxford, November 2019, 16.

It was therefore not surprising that as summer gave way to autumn that yet more gas was pumped into storage, the European Commission, together with the Member States went into full crisis planning mode to deal with the now expected third European gas crisis. The EU and its Member States hoped that a deal under the continuing trilateral negotiations would be possible but were now preparing for the worst.

The Deal, a Temporary Solution?

Despite those very real concerns as to the prospect of a third European gas crisis very late on 30th December 2019, Ukraine and Naftogaz came to a series of agreements which secured gas flows across the Ukrainian transit route for a further five years. Gazprom agreed to ship or pay (ie if it did not ship it would still have to pay for the gas transit) a minimum of 65bcm in 2020 and thereafter a minimum of 40bcm to the end of 2024. These minimum transit gas flows across Ukraine should ensure that Ukraine receives approximately $7 billion between 2020 and 2024 in transit fees[3]. In parallel, Gazprom paid the $2.56 billion (plus interest making it $2.9 billion) awarded in Stockholm, while Naftogaz cancelled its further Stockholm claim of an additional $12 billion. The Ukrainian Cabinet of Ministers also cancelled an antitrust fine against Gazprom levied by the Antimonopoly Committee of Ukraine for abuse of dominance, amounting to $7 billion.

The deal as it stands clearly has significant positive value for Ukraine. It is worth remembering that the original Russian plan was for Nord Stream 2 to be in full operation in January 2020. At that point Gazprom would then have refused to sign any transit contract and that would have been pretty much the end of the Ukrainian transit of Russian gas. At the very least the new contract has extended gas transit flows across Ukraine and retained transit fees into the early 2020s. However, while the deal does provide some certainty and transit flows to Ukraine for the next five years it is not as generous as it looks. Gazprom was willing to make the $2.9 billion payment in a context where Naftogaz had already frozen Gazprom assets in a number of Western countries close to equivalent value of the award, and therefore found itself in a situation where it would have faced asset seizures if it did not pay the award. Also, by permanently withdrawing the $12 billion claim and particularly by cancelling the antitrust fine of $7 billion the deal permits Gazprom to enter the Ukrainian gas market without fear of immediate financial sanctions.

3. This estimation of transit fees is based on Gazprom only transiting the minimum level of gas flows under the new contract. If flows are above minimum levels the level of transit fees will also be higher.

Almost at the same time, on 1st January Ukraine fully unbundled its transmission system. Naftogaz will now be a production and storage company. The gas transmission system was separated from Naftogaz as the Gas Transmission Operator of Ukraine (GTSOU) and was transferred to Mahistralni Gazoprovody Ukrainy (MGU) an entity controlled by the Ministry of Finance. GTSOU, as part of the overall set of agreements with Gazprom, signed an interconnection deal with the Russian company, as well as all the Transmission System Operators of nearby interconnecting states to ensure the smooth onward flow of gas into the EU.

Hence, the Ukrainian transit system is now fully unbundled in accordance with EU energy law. Naftogaz in future will be a client of the GTSOU and will have no financial interest in the company. Naftogaz from now on will be tasked with developing the storage and developing Ukrainian gas production from its currently low base of 20bcm.

It is also the case that transparent and non-discriminatory EU rules operated by an independent transmission system operator will assist a newly liberated Gazprom to sell gas into the Ukrainian gas market.

Why did Moscow do the deal?

Approximately two weeks before the deal was done, Andrey Kobolyev, the CEO of Naftogaz said that the chance of a deal being done was 'close to zero'. There was also the prospect from Gazprom's perspective of benefiting from higher gas prices caused by a transit crisis in early January which itself created a perverse incentive to let the crisis happen. The indications therefore from Moscow, Kyiv and Brussels was that there was now a serious danger of a transit interruption on 1st January.

The key and decisive factor in changing Russian attitudes was the signing into law of the NDAA on 20th December, which in Section 7503 included sanctions on the pipe laying on Russian export pipelines. Despite Russian claims that Nord Stream 2 was almost complete, the pipeline remained significantly unfinished. The Danish permit restrictions had only allowed Gazprom's contractors to start construction in Danish waters in early December. These works stopped on 20th December. At the beginning of December approximately 300km of pipeline still needed to be laid. Most of that pipeline (around 200km) remains unlaid when sanctions came into force[4].

The initial public response of the Russian government and Gazprom to the imposition of US sanctions was to indicate that this was not too much of a problem, and that other means could soon be found to soon continue laying the pipelines. However, as Gazprom's advisers examined the text of Section 7503 they realised that the scope of the sanctions significantly reduced the company's room for manoeuvre in completing the Nord Stream 2 pipelines.

It is very easy to misread Section 7503 which imposes a range of reporting obligations with different times lines.

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What is crucial in effecting an immediate stoppage of works was the initial wind down period. This provides that operators who are currently laying pipelines for the targeted entities that the President may not impose sanctions on such operators if in the 30 days from enactment of the legislation engage in good faith efforts to wind down their operations. This created a very compelling incentive for Allseas the pipelaying operator to immediately close up and end its operations. This is what in fact Allseas did. Gazprom then faced immediate closure of its pipeline laying operations on enactment of the legislation, leaving approximately 200km of the pipeline route unfinished. It will now be difficult for Gazprom to find a replacement company to Allseas. There are only a handful of companies in the world that have such complex pipeline laying capacity, none of them is Russian. All these companies have significant commercial opportunities in US markets and with US companies, which means it is unlikely that any of them would be willing to take the risk of completing Nord Stream 2.

The second point to realise about Section 7503 is that the actual scope of the sanction is broader than it first appears. It sanctions foreign persons who knowingly, sell, lease or provide pipeline laying vessels able to lay pipelines at a depth of 100 feet or greater in respect of Nord Stream 2, Turk Stream 2 or successor projects[5].

Gazprom could potentially itself face sanctions if it even constructed its own pipe laying ship (Gazprom in terms of Section 7503 could be deemed to have provided the vessel for pipelaying). Probably the only safe way for Gazprom to proceed is to seek a Russian unconnected entity to construct and operate a pipeline laying vessel and accept that the stand-alone Russian entity would be sanctioned. The problem with that solution is that it will take some time to execute pushing the com-

4. For the most detailed discussion of the state of play at the beginning of December when Allseas began to lay pipes for Nord Stream 2 in Danish waters see Nord Stream 2 construction in Danish waters under way: contractor, S&P Global Platts, 4th December 2019.

5. It should also be noted that Section 7503 has a clause bringing within its scope any attempt to facilitate deceptive or structured transactions to provide vessels for the project.

pletion of the Nord Stream 2 project into the mid-2020s. That view is reinforced by the fact that not only does Gazprom or probably rather the Russian state have to find and possibly construct a vessel to lay the pipelines in a legal structure that will not result in the Gazprom being sanctioned, but also completion processes have to be undertaken after physical completion and certification via the German regulatory authorities. In those circumstances a reasonable estimation of time period for Nord Stream 2 to be operational is probably four or five years.

The more positive alternative scenario for Gazprom is if its pipelaying ship *Akademik Cherskiy* which is currently operating in the Pacific, is not subject to sanctions and can actually be operated at the standards required for the laying of the Nord Stream 2 pipes[6]. Even then if the physical operation is completed by the middle of 2021 Nord Stream 2 will require certification by the transmission system operator and may well face a legal battle over that certification process.

As a consequence of these risks the balance of argument in the Russian state and Gazprom shifted in the direction of doing a deal with Ukraine, rather than seek to leverage a gas crisis to its own commercial and political advantage. With sanctions in place the essential deliverable that Moscow would have wanted from the crisis would not have in any event been available: the rapid completion of Nord Stream 2.

Strategic Objectives Delayed but not Abandoned

Whilst a deal has been done, peace has not suddenly broken out. The Russian strategic objectives remain in place: to end gas transit across Ukraine, to isolate Kyiv from the West, restore Gazprom's market dominance in the Ukrainian market and return Kyiv to the Russian sphere of influence.

Clearly one way forward for Moscow with the support of Berlin would be to seek to get the sanctions lifted. As part of the compromise to get the Section 7503 included in the NDAA the President was granted the capacity to lift the sanctions on national security grounds by executive order. However, given that President Trump is facing great controversy with his Russian connections in Washington, it is unlikely that he will accede to such Russo-German lobbying to lift the sanctions at least after the US Presidential election in November 2020, assuming he obtains a second term.

The Russian Federation will adapt its strategy depending on the speed with which Nord Stream 2 is physically complete and then operational. It the pipeline can be fully operational within a couple of years, one option for Gazprom would be to entirely cease using the Ukrainian pipeline network and rely on Nord Stream 2 pipeline and the other export pipelines to the EU. This would result in Naftogaz bringing an arbitration case to recover lost transit fees against Gazprom which it would certainly win. However, it would take time, and by that point be a claim for only $3-4 billion in fees and in any event not result in the restoration of Russian use of the Ukrainian transit network.

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It is clear that with Nord Stream 2 and Turk Stream 2[7] in place Gazprom would have sufficient export capacity for its gas flows to the EU. Gazprom will have 55bcm of export capacity from Nord Stream 1, 33bcm from Yamal, 15bcm from Turk Stream 2, and 55bcm from Nord Stream 2. This is a total of 158bcm in export capacity. This capacity is likely to be available from 2022 or if a new pipeline laying vessel is required to be commissioned 2024.

EU law could have a bearing on limiting capacity in respect of Nord Stream 2. However, even if the European Commission fully applies the judgment of the General Court in the *OPAL* case it is doubtful that such restrictions will stop the termination of Ukrainian gas flows. In *OPAL* the General Court required Member State regulators when assessing the terms for the application of an exemption decision to consider the principle of solidarity. This solidarity assessment includes considering the supply security interests of all Member States, and not just their interests of the Member State of the regulator assessing the project[8]. Even if applying the criteria of the *OPAL* ruling leads to OPAL levels of capacity restriction on Nord Stream 2, of 50% that will still leave Gazprom with 130bcm of export capacity. The Ukrainian transit

6. For instance the Allseas ships had sophisticated global positioning systems available which were vital in identifying munitions lying on the seabed.

7. Turk Stream 2 will be fully operational in 2021. The pipeline is physically in place but requires the relevant Bulgarian interconnectors to be put in place so that its gas flows can reach Serbia and onward to Hungary.
8. Case T-883/16 Poland v. Commission, 10th September 2019, not yet reported.

network would be difficult to sustain on approximately 20bcm of transit flows. In any event, with the use of more compressor stations and LNG exports Gazprom should be able to make up most if not all of that supply gap.

Another major line of attack to seek to stop Nord Stream 2 would be to challenge it via European competition law. Naftogaz as part of the package of withdrawn claims has withdrawn its antitrust complaint against Gazprom in respect of Nord Stream 2 brought before the European Commission. It would be possible for third parties and other Central and Eastern Europe (CEE) states and energy companies to revive this complaint. An alternative line of legal challenge to Nord Stream 2 would be in respect of EU energy law, particularly the assessment provisions for exemption and certification assessment under the Gas Directive 2009[9]. A third line of legal challenge would be the ongoing Polish NGO challenge to the granting of the Danish route permit in October 2019. The imposition of US sanctions and the ending of works on the pipeline give the Danish authorities time to fully consider the appeal before Nord Stream 2 works are recommenced.

Absent the success of such legal challenges this analysis suggests therefore that Ukraine has at best a five year window to take steps to protect itself from looming Russian gas dependency and all that entails. Positively, in 2022 the Baltic Pipeline comes on stream. This will bring a 10bcm capacity pipeline from the Norwegian gas fields to Poland and the Polish government is also planning to expand its LNG capacity and plans are afoot to expand Polish-Ukrainian export interconnectors. Naftogaz now free of the transmission system, can focus on further development of storage and production capacity. In respect of the latter it could seek to significantly boost production from its current 20bcm plateau. A mix of domestic production increase and greater access to non-Russian CEE imports via Poland could strengthen Ukrainian energy security. In the longer run, Naftogaz could seek to boost domestic production to cover total Ukrainian demand, and seek then to be an exporter of gas and energy security to CEE allies.
However, should energy liberalisation stall in the early 2020s or indeed roll back, with interconnectors with EU countries such as Poland not expanded and domestic gas production not raised significantly, then Moscow is likely to find itself in a strengthened position vis-a-vis Ukraine by 2024. Kyiv would find itself without transit revenues across Ukraine. It would also find itself without reverse flows of gas from the EU that is currently carried by the Ukrainian transit system[10].
These supply security weaknesses would be reinforced by the re-entry of Gazprom to the Ukrainian gas market following the transit deal. One of the dangers of the deal is that even before Nord Stream 2 comes on stream, Gazprom will seek to dump gas at very low prices on the Ukrainian market (in competition law terms this can constitute predatory pricing) to gain market share and political influence, driving out other market actors. Such dumping could be reinforced by the re-introduction of a range of intermediate companies entrenching Russian power and influence into the Ukrainian gas market.

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To counter such threats Ukraine and its allies should consider a number of steps. The first is for the EU and the US to assist in funding interconnectors between Poland and Ukraine and expanding storage capacity in Ukraine. This would speed up the process by which Ukraine became more firmly integrated into the European gas market and would ensure greater access to alternative supplies.

In theory Ukraine could deploy its own regulators such as the Anti-Monopoly Committee of Ukraine and other market regulators to tackle dumping and the creation of intermediate firms in the energy sector. However, there are questions of capacity, credibility and effectiveness which suggest that an alternative solution may be required. One option would be for Kyiv to seek to add a protocol to the Energy Community Treaty. It already has jurisdiction in the energy sector in Ukraine since 2011. Ukraine would seek a protocol that would give the Energy Community's Secretariat the power to act as the ultimate regulator for the gas and electricity sector[11]. The Secretariat would then be able to effectively protect the Ukrainian market against abusive market behaviour such as predatory pricing by initiating its own proceedings.

9. This would include an exemption decision under Article 36 and potentially a supply security test under Article 11.

10. Since 2014 Ukraine has not consumed any gas contracted from Gazprom. Instead it has bought natural gas from its European neighbours. Principally this has been gas received on reverse flow via the Ukrainian pipeline network. In other words this has been Gazprom gas contracted to European Union customers that has been resold by those customers to Ukraine. If the Ukrainian pipeline is no longer operational it will not be possible to opt for reverse flow deals to keep imports from the West flooding into Ukraine. It may be possible to obtain some 'reverse flow' gas from Poland (as well as non-Russian sourced gas) but because of the influence and part ownership by Gazprom on pipeline networks along the OPAL and EUGAL connecting pipelines it will be much more difficult for Ukraine to obtain gas on reverse flow.
11. Ordinarily the local regulator would undertake cases, however, cases could either be referred to the Secretariat by the local regulator or in the largest and most significant cases the Secretariat would have the capacity to initiate procedures.

Given the need for speed Ukraine could seek agreement with the other Contracting Parties of the Energy Community to a protocol where Ukraine would accept without the need of other Contracting Parties to be so bound. Given the broad advantages in terms of attracting investment it is probable some Contracting Parties would join with Ukraine and most other if not all Contracting Parties would join later.

The Protocol would permit the Secretariat, which has a similar function to that of the European Commission, in its surveillance and investigative role, to bring direct actions against companies operating on the territory of its member states. The protocol would strengthen the judicial structure of the Energy Community and provide for an enforcement mechanism.

The danger however for Kyiv is that if it does not move swiftly to fully integrate itself into the European energy market, and take steps against predatory pricing and intermediate energy companies then it may find itself falling back into dependence on Russian gas, Russian influence and back again under the shadow of Moscow.