



Negotiations on Maintaining Gas Transit via Ukraine

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The trilateral gas talks between the European Commission (EC), Ukraine, and Russia that resumed in July face serious challenges. The reasons for that include the Russians' attempt to link the negotiations to other issues and Ukraine's stalled gas market reforms. Furthermore, the EC does not have formal tools to influence either country. This may change if EU Member States support amendments to the gas directive and the mandate for the EU-Russia negotiations on the status of the Nord Stream 2 (NS2) pipeline project. However, this will require countries that support the pipeline construction to overcome their reluctance to back the changes.

Gas Transit via Ukraine: Technical Aspects. Ukraine's gas transmission system (GTS) has considerable transit capacity but Russia's political goal is to limit Ukraine's role by constructing pipelines that do not include it. Ukraine's GTS has about 142 bcm of annual transit capacity to Europe. In 2004, it transited about 137 bcm, and in 2011, around 104 bcm. In November 2011, deliveries through Nord Stream 1 started and as a result, in 2014, gas transit via Ukraine dropped to a record low 62 bcm. However, Russian gas exports to Europe rose in the following years and transit via Ukraine's GTS increased to more than 90 bcm. Russia's NS2 and other projects aim to limit this dependency.

NS2's construction, with an annual capacity of 55 bcm, its land portion in Germany (the EUGAL pipeline, 55 bcm total capacity) and two lines of TurkStream going to Turkey (15.75 bcm each, one which will be an alternative to transit via Ukraine to the Balkans) will allow Russia to limit its dependence on Ukraine's GTS. Gazprom allows for the possibility of maintaining minimal gas transit via Ukraine (10-15 bcm) for short-term deliveries to Europe during higher demand periods. That volume, however, is not acceptable for Ukraine, which states the minimal volume to ensure the technical operation of the GTS is about 30 bcm. The trilateral gas talks are meant to forge a consensus on gas deliveries to EU via Ukraine; however, it is unclear which gas volumes will be discussed.

Ukraine: Gas Transit Concerns, Stalled Reforms. Ukraine's goal is to maintain gas transit at a level that at least ensures the profitability of its GTS, which according to the Ukrainian experts, is 50-60 bcm. Keeping gas transit below the profitability level would force Ukraine to subsidize its system or permanently limit its capacity. Ukraine's concerns are all the more urgent because Gazprom is pushing to quickly complete the alternative pipelines circumventing the country. Ukraine's completion of the gas market reforms, ensuring the transparent and competitive functioning of the GTS, would help it during the trilateral talks. This would encourage western companies to invest and help manage the Ukrainian pipelines, a scenario supported by the EC.

It would also make the next negotiation rounds easier by reducing the number of disputes (extending EU law to the GTS will be discussed during future trilateral talks). Despite the fears related to NS2 construction, the reforms have been stalled so far by internal political disputes and have hampered the unbundling process (separating gas transmission operations from Naftogaz to a new company, MGU). What is more, Ukraine needs Gazprom's consent to such a change as it would require a change of party in the gas-transit

contract between Naftogaz and the Russian company.¹ Therefore, unbundling is only possible after the current gas transit contract expires at the end of 2019. Despite the obstacles from the Russian side, conditional certification of the GTS operator in accordance with EU law is possible but requires action from Ukraine on unbundling. A recent memorandum between Naftogaz and MGU in this matter may be a positive sign.

Russian Goals and Tactics. Russia has suggested it does not intend for Gazprom to sign a new gas transit contract, therefore limiting transit via Ukraine's GTS, but also has linked the transit negotiations to other issues. The signing of a new transit contract is tied with "settling" Gazprom's legal dispute with Naftogaz, as stressed even by President Vladimir Putin himself. The Russian company refuses to pay a \$2.56 billion penalty awarded by the Stockholm arbitration court over various matters, including smaller gas shipments via Ukraine's GTS than the 110 bcm agreed in the contract. In response, Naftogaz started to freeze Gazprom assets in Europe to repay the debt.

Russia's actual negotiating position seems weaker than its leaders' statements suggest. The transit contract expires in 2019, when NS2 should be completed. However, the new pipeline requires the construction of the two EUGAL lines, which will be completed only at the end of 2019 and 2020, respectively. At the same time, NS2 construction faces additional risks, such as Denmark's blocking pipeline laying in its territorial waters or new sanctions imposed by the U.S. The combined capacity of NS2 and TurkStream's second line (70.75 bcm) would leave a small volume of gas to be transited through Ukraine's GTS. Gazprom also claims that the demand for Russian gas in Europe will grow, which would allow Ukraine to maintain a portion of the transit business.

It is not clear, whether Russia's stance is part of a negotiating strategy to gain additional benefits or a way to sabotage the negotiations and force a return to bilateral talks with Ukraine. If Russia's terms are prohibitive and result in a fiasco in the negotiations, the Russians will try to depict Ukraine as an unreliable partner while also promoting NS2 as the guarantee of stable supplies to Europe.

EC's Role and Powers. The EC is using the trilateral talks to secure stable gas supplies to the EU. However, the situation is complicated by the expiration in 2019 of the 5-year term of the Juncker Commission. Also, it has limited scope for effective direct action and serves more as a moderator between Russia and Ukraine. This could change with the EC-supported amendments to the EU gas directive and adapting the EC's mandate to negotiate NS2's legal status with Russia, but that would need the support of the EU Member States.² Together with Ukraine completing the gas market reforms would give the EC the tools it needs to oversee the functioning of both NS2 and GTS so that both routes could compete on competitive terms. In the current state of play, despite Naftogaz's claim it will lower its transit fees, it is impossible to verify how this would translate into increased competitiveness against NS2.

Germany recently came out in strong support of the trilateral talks and the first round of the negotiations took place in Berlin. However, the Germans are not formally part of the talks, though they hope an agreement will be reached. Germany aims to weaken criticism by its allies and reduce the controversy surrounding NS2³ to just the issue of transit via Ukraine. At the same time, Germany strongly supports NS2 and blocks initiatives that would ensure transparency in its operation.

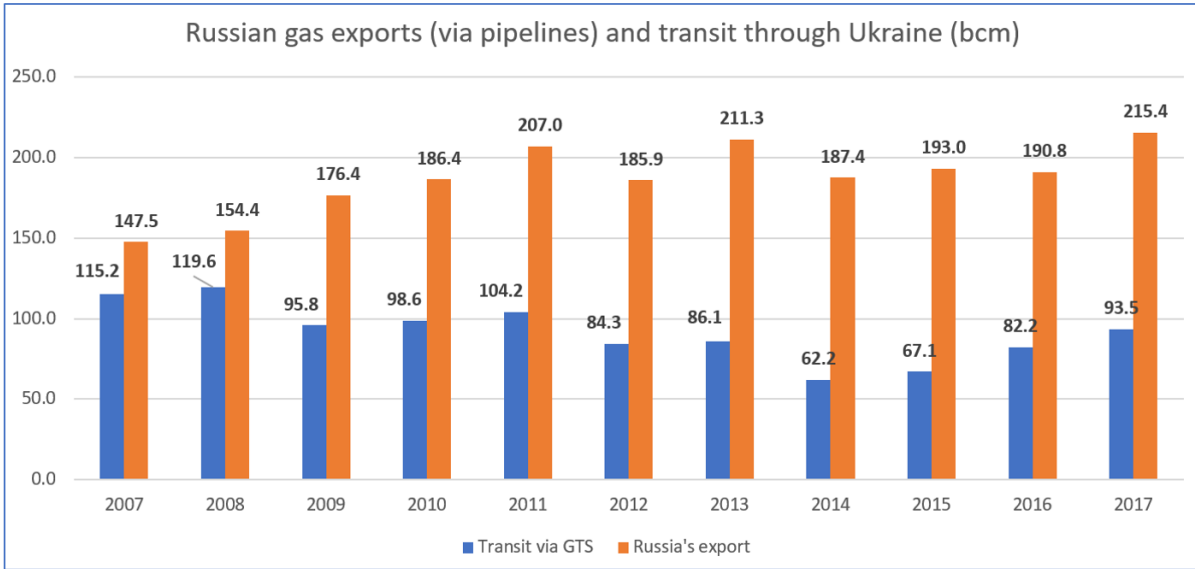
Conclusions and Recommendations. The troubles related to the trilateral gas talks stem in part from the serious Russia-Ukraine tensions, which make reaching agreement more difficult. The EC could play a more active role if it had the support of the EU Member States for the gas directive amendments and a mandate for negotiating NS2's status with Russia. However, that would require the support of countries like Germany and Austria, which want to quickly finish the construction of NS2.

Poland can help in reaching an agreement in the trilateral gas talks. To do this, it is important to persuade Austria, which currently holds the presidency of the Council of the European Union, to immediately quicken the processing of the gas directive amendments and the mandate for NS2 legal status negotiations—a move which would be the realisation of Austria's declared "building bridges" EU policy. Poland, together with the EC could also push Ukraine to complete the reforms of its gas market, which would pave the way to investment and management of its GTS by European companies. That would then make future negotiating rounds easier since the talks could focus on other controversial issues. Poland also could propose Warsaw as host of the next trilateral round.

¹ B. Bielszczuk, D. Szeligowski, "Ukraine: Naftogaz Restructuring in Question," *PISM Bulletin*, No. 26 (1097), 13 February 2018.

² B. Bielszczuk, "Competition under Control: A Perspective on the Application of EU Law to Nord Stream 2," *PISM Bulletin*, No. 122 (1062), 6 December 2017.

³ A. Gawlikowska-Fyk, M. Terlikowski, B. Wiśniewski, S. Zaręba, "Nord Stream 2: Inconvenient Questions," *PISM Policy Paper*, No. 5 (165), 3 July 2018.



Sources: Naftogaz, BP Statistical Review of World Energy.