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NEWSLETTER

German Economic Team

UKRAINE

The new Russia-Ukraine gas agreements

Gas negotiations between Russia and Ukraine were ultimately successful: a package of agreements has been reached which allow Russian gas to be transported through Ukraine for five years at a roughly 50% level compared to average volumes of the past five years. Enabling factors included the successful unbundling process of Naftogaz in a race against time, Ukraine's focus on achieving short-term gains, Russia's willingness to bend to the Stockholm arbitration awards payment. With sanctions from the United States on Nord Stream 2, Russia was plunged into uncertainty over the opening of this alternative route and compelled to secure a longer and larger deal with Ukraine than it initially considered. Next issues to watch for are two remaining legal disputes, Gazprom's possible direct gas supplies to Ukraine, and the fate of the Yamal-Europe transit pipeline.

Background

There were multiple reasons for the Russia-Ukraine gas negotiations to fail and for another gas crisis to occur:

Russia has been very critical of the 2018 Stockholm arbitration awards favourable to Naftogaz (net USD 2.6 bn win plus interests), calling them political and partial –and Gazprom appealed the rulings. Yet Naftogaz systematically sought to obtain payment/compensation and raised the stakes with additional arbitral claims.

Russia was in no hurry and in no need to sign a long-term deal as proposed by Ukraine and the European Commission (EC): Nord Stream 2 and TurkStream were coming imminently and Ukraine's tariff proposals were considered too high.

Ukraine had two key elections in 2019 and faced a Hercules task: proceed with the unbundling of the gas transmission operator in a record time of four months.

Both Gazprom and Naftogaz had well prepared for a gas crisis and so did the gas industry: storage levels were highest both in Ukraine and in the EU and prices so desperately low that a crisis would have been good for traders.

The EC and Germany did not have much to pressure sides to compromise and unsurprisingly, the first rounds of negotiations were inconclusive.

So how come Gazprom and Naftogaz finally managed to finalise a package of agreements on 31 December?

A narrow and unexpected road to success

First, contacts and negotiations were frequent over past months, at the right level of interlocutors both on the Ukrainian and Russian side. After some episodes of nerve-playing, the 9 December Paris Normandy format summit was certainly helpful too. The EC's steady mobilisation alongside Germany's facilitation were also key.

Second, Ukraine proved to be surprisingly efficient and well prepared. The unbundling and certification of the Gas Transmission System Operator of Ukraine LLC (GTSOU) (now controlled by JSC Trunk Pipeline of Ukraine) was achieved in a record time, with full alignment of Naftogaz, the Ukrainian government, Parliament and regulator, the EC and Energy Secretariat. The Naftogaz strategy was coherent and transparent.

Thirdly, President Putin finally got involved. A halt in the transit would have pushed LNG imports into Europe further and reinvigorated the debate over Russia's "toxic" gas at a critical time for the EU gas industry. Endlessly battling the Stockholm rulings would have harmed Gazprom's reputation, assets and ability to raise debt. Neither the internal tensions among some Ukrainian individuals, nor the unbundling process, derailed: there was no window to blame Ukraine. Ultimately and perhaps, more decisively, US sanctions on Nord Stream 2 changed Russia's calculations: when it became clear that there would be no possibility to quickly wrap up works as Trump unexpectedly and rapidly signed the NDAA sanction bill on 21 December, and that the 30 days "wind down" conditions were strict, the arms wrestling turned in Ukraine's favour. Russia faced a longer gas exports gap that would have meant lower revenues for Gazprom, loss of reputation, more room for competitors and ultimately, a weakened financial position which the starting exports to China would not have offset. Russia's only pipe-laying vessel was months away and not ready (and perhaps able) to intervene.

The terms of the gas agreements

Main provisions of the agreements include:

Gazprom paid back its USD 2.9 bn outstanding debt for the 2018 Stockholm arbitration awards; All remaining mutual claims between Gazprom and Naftogaz are withdrawn. Ukraine's anti-monopoly committee revoked its multibillion antitrust claim against Gazprom.

Gazprom committed to a 5 years transport agreement with Naftogaz (with an option for a 10 year extension, Naftogaz then agreeing its terms with GTSOU so that Gazprom faces no tariff uncertainty): a minimum of 65 bcm in 2020 (Gazprom sharply reduced transit in early January to use its gas stored in the EU and push prices up), and then 40 bcm/year until 2024; volumes are expected to be slightly higher given limitations on OPAL and delays with Nord Stream 2 unless Gazprom reduces its overall exports or books large capacities on the Yamal-Europe pipeline.

An interconnection agreement has been concluded between Gazprom and GTSOU, which will allow virtual reverse flows in the Ukrainian system and also enable direct gas sales by Russian companies to entities in Ukraine. Also, the Ukrainian transmission system operator could gain flexibility in managing gas flows in transit and deliveries to Ukraine, in netting volumes going from Russia to Europe and those ordered in reverse flow.

Transportation tariffs stay at roughly the 2019 level but exact proportions, and ship or pay clauses guaranteeing for example volumes and payments, are not publicly available.

There will be gas

Russia, Ukraine, Slovakia (which shares similar interests to Ukraine) and the EU are all short-term winners. Gazprom's financial perspective and reputation are improved. The image of gas in the EU is safe. President Zelensky's agenda of reforms and growth can be backed by a total of about USD 10 bn payments from Gazprom until 2024 (minimum transit plus arbitration), which will partly be redistributed as dividends to the state budget. Ukraine's internal gas prices will not soar due to higher transport tariffs. Naftogaz is expected to focus on developing profitable storage services, maximising profits from upstream production and sorting out problems in the regional distribution segment.

Yet Ukraine has no transit certainty beyond five years. No major pipeline modernisation programme can be done on that basis. Claims related to the seizure of Chornomorneftegaz assets in Crimea remain a priori excluded from the agreement. Russia may also seek to resume direct gas supplies to Ukraine, not necessarily through Naftogaz, in order to re-establish special ties and/or benefit from this liquid market. In the meantime, Poland is left with the uncertainty over the future use of the Yamal-Europe pipeline, whose contract terminates in May 2020.

The EU must now consider how to respond to US interference in EU's policies (or the lack of it). Lower geopolitical tensions between Russia and the EU, if confirmed, could also open the way for a comprehensive discussion about the decarbonisation of gas and how Russia and the EU can work together to fight climate change.

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