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## After the Gazprom-Naftogaz arbitration: commerce still entangled in politics

### Introduction

On 28 February, nearly four years after Gazprom and Naftogaz Ukrainy initiated proceedings against each other at the Arbitration Institute of the Stockholm Chamber of Commerce, the tribunal dealing with the cases issued its final decision on the contract covering transit of Russian gas through Ukraine in 2009-19.<sup>1</sup> This complements decisions issued last year on the parallel supply contract.

It will be argued below that the tribunal – although criticised by Gazprom for reaching ‘asymmetrical’ conclusions – sought to limit itself to the commercial issues in the contract, and to leave out of account associated political and strategic issues. This might have been expected to provide the basis for a line to be drawn under past disputes and for agreements on post-2019 transit to be concluded on a commercial basis, despite political tensions.

The initial reaction of the parties – and in particular Gazprom’s decision not to restart direct gas exports to Ukraine as had been expected, to appeal against the tribunal’s decision on procedural grounds and to start proceedings to terminate the contracts – suggests that such a turning point has not been reached. In European political circles, these events may reinforce calls for reducing dependence on gas in general and Russian gas in particular.

As for the Russo-Ukrainian relationship in the sphere of gas, the tribunal’s decision looks like another step on the road to its end. Direct imports will probably cease after 2020. Transit can not stop at that time, but could stop, or be reduced to a bare minimum, in the mid 2020s. Prospects for a revival of a wider relationship probably depend on a substantial improvement in political relations, of which there is no sign at present.

Ultimately, commerce has been unable to disentangle itself from politics.

In the early 2010s, before the arbitration started, commercial factors had, in fits and starts, begun to shape the relationship between Gazprom and Naftogaz; political factors that had previously played a strong part were apparently receding in importance. Then political factors leaped to the fore again, in 2014. The overthrow of the Yanukovich government, Russian annexation of Crimea, and the creation of Russian-supported separatist enclaves in eastern Ukraine, have produced a state of extreme political hostility between Russia and Ukraine. The arbiters’ decisions offered the opportunity for a continuing, albeit reduced, Russia-Ukraine relationship in the gas sphere, underpinned by commercial principles – but the events since the arbitration finished indicate that this opportunity may not be taken. One

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<sup>1</sup> With thanks in particular to Ralf Dickel, James Henderson and Jonathan Stern, who read and commented on the text, and to many people who have discussed the issues with me. The views expressed, and any mistakes, are mine alone. SP.

possibility is re-politicization: the decline of Russo-Ukrainian gas relationships, against the background of political and military conflict; and the slowing-down of this decline only e.g. by agreements on transit brokered by the European Commission.

## The background

The two contracts under dispute were signed in January 2009, after the so-called ‘gas war’ between Russia and Ukraine (1-17 January), during which deliveries to some destinations, especially in south-eastern Europe, were curtailed.<sup>2</sup> The conclusion of the contracts on 19 January 2009 marked a step towards the commercialisation of the Russia-Ukraine gas relationship. They were the first agreements to be concluded solely between the companies involved, without an underlying intergovernmental agreement. The agreements also amounted to a step away from previous arrangements, under which aspects of both the importation of Russian gas by Ukraine, and the transit of Russian and central Asian volumes to Europe, were dominated by unaccountable, privately-owned intermediary companies, whose business strategies depended on political influence and opaque management.

The contracts were seen in Ukraine as damaging to the national interest. Successive governments, and successive management teams at Naftogaz, requested renegotiation. In 2010, there was a relative easing of political tension, with the election of Victor Yanukovich as president of Ukraine. There followed a political agreement, signed in April of that year, under which (1) a discount of roughly \$100/mcm was applied to the price of Russian gas exported to Ukraine, funded by the Russian treasury, in exchange for a political concession (a 25-year extension on Russia’s lease from Ukraine of the Black Sea naval base), and (2) some terms of the 2009 agreement, that Naftogaz argued were punitive, were softened.

Between 2010 and 2013, imports and transit of gas continued under the contracts. Transit volumes were below, and import volumes substantially below, the annual contract quantities (ACQs). Ukraine sought to diversify its gas supply, cancelling Naftogaz’s import monopoly in 2011 and initiating ‘reverse flow’ deliveries from European suppliers in 2012. Calls were repeatedly made in Ukraine for further amendments to the contracts; Russian political leaders repeatedly responded that such renegotiation was dependent on Ukraine dropping its long-standing opposition to Russian ownership and/or control of the Ukrainian transport system. The contracts were finally amended in December 2013, during the Ukrainian political crisis triggered by Yanukovich’s failure to sign an association agreement with the European Union (EU). Russia shifted its position, and agreed, without any progress on its hopes of taking control of transit, – to a substantial reduction in gas import prices (from around \$402/mcm in the fourth quarter of 2013 to \$268.50/mcm in the first quarter of 2014). This change was not gas-related, but was part of a larger package of trade measures, agreed between Yanukovich and President Putin.

In March 2014, Yanukovich’s government was overthrown, and Russia annexed Crimea. In May 2014, separatist ‘republics’ were established in eastern Ukraine with Russian support. This put the agreement on import prices, along with many other aspects of Russo-Ukrainian relations, in question. There followed trilateral political negotiations between the European Commission, Russia and Ukraine, covering a number of issues including natural gas imports. The Russian government proposed that imports for the second quarter be priced at \$385/mcm, that is the contract price (\$485/mcm) with the application of the \$100/mcm discount that had been agreed in 2010. The new Ukrainian government, and the new Naftogaz management team, argued that – since that discount had been funded by the

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<sup>2</sup> This account summarises material from: Pirani, S, Stern, J and Yafimava, K, (2009) ‘The Russo-Ukrainian gas crisis of January 2009: a comprehensive assessment’, NG27, OIES. <https://www.oxfordenergy.org/publications/the-russo-ukrainian-gas-dispute-of-january-2009-a-comprehensive-assessment/> and Pirani, S, Stern, J and Yafimava, K, (2010). ‘The April 2010 Russo-Ukrainian gas agreement and its implications for Europe’, NG24, [https://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/05/NG\\_42.pdf](https://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/05/NG_42.pdf), and Pirani, S and Yafimava, K, (2014). ‘CIS Gas Markets and Transit’ pp. 181-215, in Pirani, S and Henderson, J (eds.), *The Russian Gas Matrix: how markets are driving change*, Oxford: OIES, and Pirani, S, (2017). ‘Adversity and reform: Ukrainian gas market prospects’, *Energy Insight No 7*, OIES. <https://www.oxfordenergy.org/publications/adversity-reform-ukrainian-gas-market-prospects/>.

Russian government in exchange for the Black Sea naval base lease extension, and that the territory on which the base is situated had now been annexed – the discount was moot. Once again they proposed a renegotiation of the gas sales contract.<sup>3</sup> The Russian side opted instead to fall back on the contract terms, and at that point mutual claims were taken to arbitration.

In the summer of 2014, Naftogaz ceased imports of Russian gas entirely. In the fourth quarter of 2014, imports were resumed at a much lower level, under a ‘winter package’ agreement, covering both transit and imports, brokered by the European Commission.<sup>4</sup> A similar agreement was put in place in the winter of 2015-16. Naftogaz, having bought 2.37 bcm of Russian gas in the fourth quarter of 2015, then ceased direct imports again, and there have been none since then. The import and transit volumes are summarised in Table 1.

**Table 1: Gas transit and imports under the contracts**

Year		2009	2010	2011	2012	2013	2014	2015	2016	2017
Imports	Under contract	26.9	36.5	40	24.9	12.9	14.5	6.1	0	0
	Other	0	0	4.8	8.0	15.0	5.1	10.3	11.1	14.1
Transit volume		95.8	98.6	104.2	84.3	86.1	62.2	67.1	82.2	93.4

Source: Gazprom and Naftogaz Ukrainy

Note. Under the contracts, the import ACQ was 40 bcm in 2009 and 52 bcm from 2010 (with an 80% take-or-pay level), and the transit volume ACQ 110 bcm.

Note. Transit volumes were all transported to the EU, except for 2.5-3.5 bcm/year to Moldova.

The largest claims in front of the tribunal were: from Gazprom under the take-or-pay clause of the supply contract, and for payment of the full contract price for the second quarter of 2014; from Naftogaz for amendment of the price and price formation mechanism in the supply contract, for failure to use contracted transit capacity and for amendment of the transit terms and tariffs. The total claims lodged were reported most consistently as \$38.7 billion by Gazprom (plus \$5.3 billion in additional claims made in early 2017), and \$26.6 billion by Naftogaz,<sup>5</sup> leading to suggestions that the arbitration case was the largest ever. All the claims were dealt with by one tribunal. Since the results of arbitrations are not made public, the account that follows relies on statements by the two parties, Gazprom and Naftogaz, press reports, and discussions in the industry.

## What the tribunal has decided

### Supply contract: price formula and price level

Naftogaz’s claim against Gazprom under the supply contract was for revision of the price, on the grounds that it was at variance with the market. Naftogaz claimed that it had been overcharged by Gazprom for gas purchased between May 2011 and April 2014. At the time the claim was made, this part of it was reported to be \$6 billion.<sup>6</sup> The tribunal accepted that price revision was required, and ruled that sales should be priced at the level quoted on NetConnect Germany (NCG), the German gas exchange. It rejected Naftogaz’s retrospective claims, and applied its ruling only to the period from the

<sup>3</sup> Pirani, S, (2014). ‘Ukraine’s imports of Russian gas: how a deal might be reached’, *Oxford Energy Comment*, <https://www.oxfordenergy.org/publications/ukraines-imports-of-russian-gas-how-a-deal-might-be-reached/>

<sup>4</sup> *Zerkalo Nedeli*, 31 October 2014, ‘Gazovyi kompromiss dlia Ukrainy tsenoi v \$4.6 mlrd’.

<sup>5</sup> See for example, UA Energy/Tsenzor, 2 August 2016, ‘Vzaimnie pretenzii Naftogaz i Gazproma’, and *Platts European Gas Daily*, 31 January 2017, ‘Gazprom to add Ukraine bill to arbitration claim’.

<sup>6</sup> Gazprom IFRS Consolidated Financial Statements, 31 December 2014, 55, <http://www.gazprom.com/fi/posts/91/415561/gazprom-ifrs-2014-12m-en.pdf>.

lodging of the arbitration claim, April 2014, and the cessation of direct gas sales by Gazprom to Naftogaz in November 2015.

The tribunal's decision dealt with underpayment by Naftogaz for gas offtaken in the second quarter of 2014, when the price to be paid was in dispute. The tribunal ordered Naftogaz to make a payment of \$2.02 billion, plus \$600,000 for each day the payment is not made after 22 December 2017 (the date of the ruling), reflecting interest accruing on the amount outstanding.<sup>7</sup> It has been reported that this payment implies a price, for gas purchased by Naftogaz in the second quarter of 2014, of \$352/mcm, compared to the price invoiced by Gazprom, under the contract, of \$485/mcm. Naftogaz's claim had implied that the price should be reduced to \$268.50/mcm.<sup>8</sup>

The tribunal's decision that, from 2014 onwards, the NCG was a more accurate reflection of the market level than the price in the 2009 contract is worthy of comment. In the 2000s, only the UK and the Netherlands had fully mature gas trading hubs. NCG and Gaspool, the two German exchanges, only started trading in 2009; in 2014 they were handling increased volumes. An OIES research project on the evolution of hubs designated the German traded market as mature only from that year onwards.<sup>9</sup> The tribunal's decision amounts to further confirmation of the trend away from oil-linked pricing, and towards hub pricing, in long-term gas sales contracts in Europe.

Moreover, the tribunal, by using an alternative price formation mechanism, appears to have skilfully avoided considering the discounts applied to the contract by decision of the Russian government. It focused on commercial issues, and left out of account associated political issues – wisely, it could be argued.

### **Supply contract: take-or-pay clause and 2018-19 sales**

In November 2014, Gazprom lodged a claim against Naftogaz under the take-or-pay clause, for failing to take contracted volumes between 2010 and 2014. At that time it was reported at \$18.3 billion.<sup>10</sup> From November 2015 onwards, Naftogaz ceased taking direct imports of Russian gas entirely. In January 2017, Gazprom invoiced Naftogaz for a further \$5.319 billion under the take-or-pay clause, for volumes contracted but not taken in 2016, and Naftogaz announced publicly that it would not pay this until the arbitration was completed.<sup>11</sup> The tribunal joined all these matters to Naftogaz's claims against Gazprom that were already under consideration.

The tribunal rejected the retrospective aspect of this claim, as it had done with Naftogaz's claim of overpayment, that is, it only considered the claim for the period from November 2014. For 2014-17, it is reported that the tribunal decided that the 'winter packages', negotiated between Gazprom and Naftogaz with the support of European Commission officials, overrode the contract's take-or-pay provisions.

For 2018-19, the tribunal ruled that the take-or-pay clause will remain in force, but at a much lower level. The ACQ of gas to be delivered under the contract is reduced from 52 bcm to 5 bcm. The take-or-pay clause covers 80 per cent of the ACQ, which is therefore 4 bcm/year in 2018-19.

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<sup>7</sup>Platts *European Gas Daily*, 3 January 2018, 4.

<sup>8</sup>Deutsche Bank Markets Research, 'Stockholm Arbitration ruling', 22 Dec 2017; author's notes.

<sup>9</sup>Heather, P, (2015). 'The evolution of European traded gas hubs', OIES NG104, 19-20 and 95, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/02/NG-104.pdf>; Heather, P, (2017). 'European traded gas hubs, an updated analysis on liquidity, maturity and barriers to market integration', OIES, *Energy Insight 13*, especially p. 5, <https://www.oxfordenergy.org/publications/european-traded-gas-hubs-updated-analysis-liquidity-maturity-barriers-market-integration/>.

<sup>10</sup>*Interfax*, 5 May 2015. 'Summa iskov Gazpromu k Naftogazu sostavila \$23.8 mlrd'; Prime Tass, 1 May 2015. 'Gazprom: summa pretenzii k Naftogazu prevyshaet isk Ukrainy k RF'.

<sup>11</sup>*Interfax-Ukraine*, 18 January 2017. 'Naftogaz not to clear \$5.3 bn bill'.

### **Supply contract: other issues**

The tribunal ruled that the destination clause in the contract, which prohibits resale of Russian volumes, is null and void. This may have implications for the unregulated market in Ukraine which will, over time, become more closely integrated with markets to its west. For now, though, it will have no effect, due to the lack of market regulation. The regulator has not yet set exit tariffs for gas traded westwards from Ukraine, despite being urged by traders to do so.

The tribunal ruled that Gazprom could not invoice Naftogaz for gas delivered to areas of Ukraine militarily controlled by separatists, that is, parts of Donetsk and Lugansk regions. Between 2014, when Ukraine lost military control of these areas, and the end of 2017, deliveries were reportedly valued at \$1.3 billion under the contract. Naftogaz had refused to accept the invoices, arguing that the gas was delivered through connection points over which it had no control. The tribunal implicitly accepted this argument.<sup>12</sup>

### **Transit contract: Gazprom's obligation to ship gas**

The tribunal delivered its final decision, on the transit contract, on 28 February 2018. It found that Gazprom had defaulted on its obligation to transport the minimum volumes stated in the contract, and ordered it to pay Naftogaz \$4.63 billion. Taking into account the \$2.02 billion owed by Naftogaz to Gazprom under the supply contract, and the \$4.63 billion owed by Gazprom to Naftogaz under the transit contract, the net payment required at the end of the arbitration was estimated at \$2.56 billion. This figure may have included some interest owed by Naftogaz.

The 2009 transit contract stated (Article 3.1) that the annual transit volume for the ten-year period covered would be 'not less than 110 bcm', and in 2009 would be 120.08 bcm. There was no ship-or-pay clause in the contract. It is understood that, in negotiations on the contract in early 2009, Gazprom had offered to insert such a clause, but with stiff penalties for failure to deliver transit services, and it was omitted. The then management of Naftogaz Ukrainy raised this as a problem very soon afterwards, and, when the contract was renegotiated in April 2010, requested that a ship-or-pay clause be inserted. This was not agreed, though, and was identified by the author and his colleagues at the time as a potentially fatal 'fault line' in the contract.<sup>13</sup>

In 2009-10, transit volumes were substantially lower than those stated in the contract. In 2011-12, it is understood that the parties took advantage of the provision in the contract for the ACQ of gas to be transported to be adjusted. However, as Gazprom's transit diversification policy took effect, with the Nord Stream I pipeline coming on stream in 2011-12, transit volumes fell sharply (see Table 1). It is understood that there was no further formal adjustment of the levels stated in the contract.

It appears that the tribunal's award against Gazprom reflects transit fees equivalent to the shortfall in volumes in 2009-17, that is for the duration of the contract. It is understood that the tribunal referred here to Article 3.2 of the transit contract, which provides (1) for additional agreements to be concluded to adjust the quantity of gas to be transited, and (2) in case no such agreement is reached, for the ACQ to be adjusted with reference to the minimal annual contract quantities of gas that Gazprom is obliged to deliver to European customers.<sup>14</sup>

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<sup>12</sup> *Ekonomicheskaja Pravda*, 22 December 2017. 'Sud Stokgolma reshil'. *Vedomosti*, 27 February 2018. 'Gazprom prekratil vystavliat' Naftogazu scheta za postavki v Donbass'.

<sup>13</sup> Pirani, S, Stern, J and Yafimava, K, (2010). 'The April 2010 Russo-Ukrainian Gas Agreement and its Implications for Europe' NG42, OIES, 16 and 40, [https://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/05/NG\\_42.pdf](https://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/05/NG_42.pdf).

<sup>14</sup> Article 3.2 of the contract reads: 'Annual Gas transit volumes through the territory of Ukraine and their quarterly distribution (including the perspective of these places) for coming years will be specified in Annexes to this Contract. In the event of the Parties failing to conclude this kind of Annex before the beginning of the relevant Contract Year, the transit volume of the gas which should be ensured for such year will be determined on the basis of consolidated obligations to supply minimum annual volumes of Gas in accordance with Gazprom Export OJSC contracts with European customers receiving Gas delivered as

Finally, the tribunal decision implies that Gazprom needs to transit a minimum of 110 bcm/year across Ukraine in 2018-19, or face similar penalties for the shortfall in transit volumes. The latter aspect of the tribunal's decision has considerable financial consequences for Gazprom, which has presumably booked capacity in the Nord Stream and Yamal pipelines with a view to continuing to minimise transit across Ukraine in 2018-19.

The tribunal appears to have placed greater weight on the contractual requirements for transit than on the take-or-pay provisions in the supply contract. However, the tribunal was criticised by Gazprom on other grounds: that it had accepted the argument that changing economic conditions had resulted in lower levels of gas purchases; and lower gas prices, but had implicitly rejected the argument that changing economic conditions had caused the reduction in transit volumes. Gazprom stated:<sup>15</sup>

Earlier, the same arbiters agreed with Naftogaz's explanations that the decline in the demand for gas and Naftogaz's non-compliance with its gas purchase commitments were caused by a slump in the Ukrainian economy. However, the same argument – a decline in gas purchases by European consumers as the main reason for less transit via Ukraine – was not taken into account as far as Gazprom was concerned.

The arbiters' decision certainly produced, as Gazprom stated, an 'asymmetrical' result in this sense. Clearly, though, the underlying issue is the extent to which the shift of transit volumes from Ukraine to Nord Stream was caused by economic factors. For Gazprom and its allies, the decision to go ahead with Nord Stream, made shortly after the 2009 gas dispute with Ukraine at a time of depressed European demand for Russian gas, was justified by their perception of Ukrainian transit risk and the strategic importance of transit diversification. For Naftogaz and its allies, transit diversification was not justified by economics; it provided excess transit capacity where none was needed, and was an instrument of political strategy designed to undermine Ukraine's position.

### ***On the transit contract: tariff-setting and other issues***

Naftogaz's submission to the tribunal under the transit contract included a claim that revised Ukrainian transit tariffs, set by National Energy and Utilities Regulatory Commission from January 2016, should be applied. The entry-exit tariffs were set at a level close to double the level of the tariffs in the contract, and substantially higher than others in the European market, for the period up to the end of 2019.<sup>16</sup> (Both Naftogaz Ukraine and the regulator have argued that the higher tariffs for 2016-19 were justified by the need for accelerated depreciation of the assets that would become stranded in the 2020s as a result of transit diversification by Gazprom. The tariff reform was part of Ukraine's extensive energy law reform, aimed at bringing legal and regulatory frameworks in line with those of the EU.) The tribunal rejected this aspect of the claim, and thereby implicitly reaffirmed that international contracts, such as the one under arbitration, stand above EU and national legislation, and their terms cannot be superseded by changes to that legislation.

Naftogaz also appealed to the tribunal for its rights and obligations under the contract to be transferred to Ukrtransgaz, its transportation subsidiary. In 2009, Naftogaz, rather than its transport subsidiary, had acted as the legal counterparty to Gazprom, in the transit contract as well as the supply contract, as part of efforts to commercialise and de-politicise the Russo-Ukrainian gas relationship (see above).

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transit through Ukraine's gas transport system. In this case, minimum annual obligations, in accordance with the Gazprom Export OJSC contracts, should be confirmed by an auditor.' Contract published at [www2.pravda.com.ua/ru/news/2009/1/22/87178.htm](http://www2.pravda.com.ua/ru/news/2009/1/22/87178.htm), translation published at <https://www.kyivpost.com/article/content/business/text-of-10-year-gas-transit-deal-struck-between-uk-34679.html>.

<sup>15</sup> TASS, 1 March 2018. 'Gazprom disagrees with Stockholm arbitration ruling', <http://tass.com/economy/992067>.

<sup>16</sup> Naftogaz Ukraine, *Annual Report 2016*, 85-86. [http://www.naftogaz.com/files/Zvity/Annual\\_report\\_eng\\_170608.pdf](http://www.naftogaz.com/files/Zvity/Annual_report_eng_170608.pdf). For comment, see Bros, T, (2016). 'Has Ukraine Scored an Own Goal with its Transit Fee Proposal', OIES, *Oxford Energy Comment*, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/11/Has-Ukraine-scored-an-own-goal-with-its-transit-fee-proposal.pdf>.

Whereas previous gas trading arrangements had been conducted by a range of state and private companies, the Ukrainian government intended to unify functions, and rationalise policy, through the holding company. But since 2014, the government's reform policy, strongly supported by the international financial institutions, has been directed at unbundling the assets EU-style. Nevertheless, the Stockholm tribunal declined to consider this issue, treating it as outside its competence.

## Reactions to the decision and issues for 2018-19

Gazprom managers reacted to the arbiters' decision on the transit contract with three actions that might be seen as a protest against it.

*First*, they cancelled a planned resumption of direct gas exports to Ukraine. Prior to the arbiters' decision, it had been expected that, in line with the tribunal's ruling on the supply contract, direct Russian gas exports to Ukraine would resume in March 2018, after an interruption of more than two years. The imports, priced against the NCG hub in accordance with the tribunal's decision, were expected to displace gas imported via Ukraine's western border. This put downward pressure on prices in the unregulated portion of the Ukrainian market. On 1 March, immediately following the arbiters' decision, Gazprom managers announced that the planned direct exports to Ukraine would not take place, and that Naftogaz's pre-payment for deliveries in March had been returned. The change came as a surprise to Naftogaz, which had prepared to offtake the deliveries by reducing nominations of gas from Slovakia. Naftogaz stated on 3 March that it had had to take emergency action to ensure customers were supplied with alternative volumes. Gazprom management did not present the cancellation as related to the arbiters' decision; on the contrary, Aleksandr Medvedev, deputy CEO, said that additional agreements that needed to be in place prior to delivery had not been made. No substantial sticking-point holding up such agreements was reported, however.<sup>17</sup>

*Second*, Gazprom wrote to Naftogaz on 3 March to initiate the termination of both contracts. Aleksei Miller, Gazprom CEO, commenting on this, cited the arbiters' 'double standards', that had 'essentially disrupted the balance' of the parties to the contract.<sup>18</sup> There is provision in the contract for disputes, including those leading to termination of the contract, to be resolved via Stockholm arbitration.<sup>19</sup> Presumably, after a period of 30 days (for the supply contract) and 45 days (for the transit contract), during which the two sides are required to try to overcome their disagreement, the issue will go to arbitration. The timetable stipulated implies that this would happen in early April for the supply contract and late April for the transit contract. Arbitral hearings could continue during this year and next, that is the period when attention should be focused on post-2019 arrangements.

*Third*, Gazprom has lodged an appeal with the Stockholm arbitration court against the decision on the supply contract, and stated that it will lodge a similar appeal against the decision on the transit contract by the end of this month. Vladimir Chizhov, Russian ambassador to the EU, has stated that hearing these appeals is expected to take at least six months.<sup>20</sup>

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<sup>17</sup> *Vedomosti*, 7 February 2018. 'Naftogaz ob'javil o vozobnovlenii zakupok u Gazproma'. Naftogaz Ukrainy press release, 3 March 2018. 'Russian gas blackmail fails',

<http://www.naftogaz.com/www/3/nakweben.nsf/0/352EB8F27E8173D6C2258245004B1795?OpenDocument&year=2018&month=03&nt=News&>. *Vedomosti*, 7 March 2018, 'Gazprom otverg obvineniia v narushenii resheniia Stokgolmskogo arbitrazha'.

<sup>18</sup> *Interfax*, 5 March 2018. 'Gazprom napravil uvedomlenie v Naftogaz o rastorzhonii kontraktov'. *Vedomosti*, 5 March 2018. 'Naftogaz Ukrainy poluchil uvedomlenie Gazproma o rastorzhonii gazovykh kontraktov'.

<sup>19</sup> The relevant clauses in the contracts state: 'In the event that the parties cannot reach a mutually acceptable solution within 30/45 days [30 days for a gas supply contract, 45 days for a gas transit contract] from the time of any dispute or disagreement, any dispute, disagreement, or claim in connection with this contract or its violation, termination or invalidity will be finally resolved via arbitration in accordance with the regulations of the Arbitration Institute of the Stockholm Chamber of Commerce.'

<sup>20</sup> *Vedomosti*, 6 March 2018. 'Gazprom podal appeliatsiiu na reshenie Stokgolmskogo arbitrazha', *Euractiv*, 6 March 2018. Georgi Gotev, 'Russia's EU ambassador: "Donbass is part of Ukraine"', <https://www.euractiv.com/section/europe-s-east/interview/russias-eu-ambassador-donbass-is-part-of-ukraine/>.

During these additional arbitration and appeal processes, the current contracts remain in place. They will both expire on 31 December 2019. This is presumably the basis of the assurance given by Aleksandr Novak, Russian energy minister, on 6 March – in response to expressions of concern by Maros Sefcovic, EU vice president for the energy union, on 2 March – that Russian gas deliveries to EU customers remain reliable, notwithstanding Gazprom's statements in response to the arbiters' decision.<sup>21</sup>

There has been no noticeable concern expressed about these events by the European companies that purchase Russian gas, since no physical interruption to supplies, or to transit flows, has taken place. No such interruption is expected, beyond the cancellation of the restart of Russian direct supplies to Ukraine. In European political circles, though, these events may redouble concerns about the level of European dependence on Russian gas, which are bound up with wider political tensions between European countries and Russia.

## The Russia-Ukraine gas relationship after 2019

In the medium and long term, given the opening-up of the Yamal gas fields, Russian gas exports to Europe could not only be maintained at their current level (179 bcm in 2016 and 194 bcm in 2017), but increased. Russia's reserve base will continue to provide the lowest-cost gas for export to Europe through the 2020s. The limits on Russian exports are likely to be set not by supply constraints, but by the European Commission and European governments, which are anxious to minimise dependence on Russian gas, for both strictly commercial, and political, reasons.<sup>22</sup> Important decisions about arrangements for gas transit across Ukraine after 2019, with Russia determined to reduce its reliance on Ukrainian transit, and the European Commission believing that it is strategically important to retain it, will be made in the context of these broader debates and negotiations about Russian gas imports to Europe.

### Transit diversification pipelines and transit across Ukraine

The ultimate aim of Gazprom's transit diversification strategy, to reduce gas transit across Ukraine to zero, cannot be achieved by 2020, and probably not for some years afterwards. Gazprom will certainly require some level of transit across Ukraine immediately after the current contracts expire (in 2020-21), and might continue to require some level of residual transit even if and when the first two major transit diversification pipelines, Nord Stream 2 and TurkStream, are completed.

The current situation (March 2018) may be summarised as follows. Nord Stream 2 retains its target of being operational by the end of 2019, but this is unlikely to be met. The project could be further delayed (1) on account of the Danish parliament's decision to give the government the right to block pipelines through its territorial waters, which could require Nord Stream 2 to be rerouted, and (2) the European Commission's request for a mandate from the Council of the EU to negotiate an agreement with Russia on the pipeline, and related attempts to extend EU jurisdiction offshore in this respect. TurkStream is under construction, and the first line, which will transport Russian gas to western Turkey, is due to be completed by the end of 2019. The second line, to carry Russian gas to Turkey for further transport to south-eastern Europe, could also be completed in a comparable time frame, but due mainly to regulatory issues being unresolved, it is not clear which of several alternatives (a proposed pipeline

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<sup>21</sup> *Platts European Gas Daily*, 6 March 2018. European Commission, Statement of Vice-President Sefcovic on Russian-Ukrainian natural gas situation, 2 March 2018; 'Russian gas flows to EU assured'.

<sup>22</sup> This argument is presented in: Henderson, J and Sharples, J, (2018). 'Gazprom in Europe – two 'Anni Mirabiles', but can it continue?' OIES, *Oxford Energy Insight* 29, <https://www.oxfordenergy.org/publications/gazprom-europe-two-anni-mirabiles-can-continue/>.

from Greece to Italy, expansion of the Trans Adriatic Pipeline to take Russian gas, or a Bulgaria-Turkey interconnector) will be used for onward transport of gas to European destinations.<sup>23</sup>

In 2016, in an OIES publication on post-2019 transit of Russian gas to Europe, the author and a colleague laid out a number of scenarios, depending on whether, and on which time scales, new pipeline capacity is constructed.<sup>24</sup> In early 2020, it seems certain that our scenario A\* will apply: that no new pipelines are built but that the capacity cap on the OPAL pipeline will be lifted, although the capacity cap has been lifted partially rather than completely. In this case, Gazprom would, without Ukrainian transit, be able to serve the Czech republic, Slovakia, Austria and Hungary at 2014 export levels and above, but be unable to meet a significant part of Italian demand, and be unable to make deliveries to south eastern European countries and Turkey. By the mid-2020s, as in scenario F, under which two strings of TurkStream and two strings of Nord Stream 2 are built, is likely to apply. In this scenario, even at a high level of exports totalling 180 bcm, Gazprom would be able to serve all its European markets, and Turkey, without using Ukrainian transit. The caveat that now needs to be added is that, potentially, demand for Russian gas to Europe could exceed that level. Gazprom will not realistically, therefore, be able to close the door on Ukrainian transit completely, even if and when these two pipelines are completed.

All this implies that in 2020-21, Gazprom will require 40-75 bcm/year of transit capacity across Ukraine.<sup>25</sup> If and when Nord Stream 2 and TurkStream are fully operational, the capacity required could decline, theoretically to zero, but in reality Gazprom would prefer to retain the option of transporting residual volumes across Ukraine. From the Ukrainian standpoint, Naftogaz Ukrainy executives have stated many times that they would like to maintain and develop the transit business. From the European side, the European Commission has applied substantial political pressure in support of retaining some transit across Ukraine. Following the Commission's involvement in negotiating the 'winter packages' of 2015-17 that ensured transit continued despite the Russo-Ukrainian dispute over the current contract, it is likely to be ready to broker talks on future arrangements. Maros Sefcovic, EC vice president, said, in response to the reduction of volumes by Gazprom after the Stockholm arbitration decision was announced, that the Commission 'stands ready to steer a trilateral process, which in the past has already proven to be effective'.<sup>26</sup> This referred specifically to immediate problems caused, but is likely to apply to the issue of post-2019 transit more generally.

Discussions in political and industry circles on the possible outcome of such talks have focused on three possibilities:

1. The conclusion of a medium-term-term (3 to 5 years) and more flexible transit contract between Gazprom and the Ukrainian Transmission System Operator (TSO, for example, 30 bcm/year of capacity. It is also possible that, now that Ukraine has adopted EU-compatible market rules, Naftogaz Ukrainy could buy capacity from the TSO and sell it to Gazprom.
2. A series of much shorter-term contracts for smaller volumes. This is likely if efforts to put a more robust arrangement in place fail.

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<sup>23</sup> Henderson and Sharples, 'Gazprom in Europe', 19-21, OIES, *Oxford Energy Insight 29*, <https://www.oxfordenergy.org/publications/gazprom-europe-two-anni-mirabiles-can-continue/>.

<sup>24</sup> Simon Pirani, S, and Yafimava, K, (2016). 'Russian Gas Transit Across Ukraine Post-2019 – pipeline scenarios, gas flow consequences, and regulatory constraints', OIES, NG105, <https://www.oxfordenergy.org/publications/russian-gas-transit-across-ukraine-post-2019-pipeline-scenarios-gas-flow-consequences-and-regulatory-constraints/>.

<sup>25</sup> Pirani and Yafimava, 'Russian Gas Transit Across Ukraine Post-2019 – pipeline scenarios, gas flow consequences, and regulatory constraints', OIES, NG105, 54. <https://www.oxfordenergy.org/publications/russian-gas-transit-across-ukraine-post-2019-pipeline-scenarios-gas-flow-consequences-and-regulatory-constraints/>.

<sup>26</sup> European Commission, 2 March 2018. 'Statement of Vice-President Sefcovic on Russian-Ukrainian natural gas situation in March 2018', [http://europa.eu/rapid/press-release\\_STATEMENT-18-1505\\_en.htm](http://europa.eu/rapid/press-release_STATEMENT-18-1505_en.htm).

3. The shifting of the delivery point in Gazprom's current long-term sales contracts from Ukraine's western border, and other European sales points, to the border of Russia and Ukraine. This approach, long supported by the Ukrainian government and European politicians, has no obvious commercial rationale from Gazprom's point of view. First, the company would need to reopen negotiations on its long-term contracts with major European purchasers. Second, selling gas on the Russian border would set a precedent with unpredictable and potentially undesirable consequences. Gazprom's major European customers have also been lukewarm to this proposal, which implies a big upheaval in trading arrangements. And finally, the political context, of Russia's relations with Ukraine and European countries at a low ebb, is not conducive to a move in this direction. All these things considered, it is unlikely.

These three possibilities apply to the period up to the mid 2020s. Thereafter, it is possible, assuming no thawing of political relations, that only residual volumes that cannot be transported by other routes will be transited across Ukraine. This could imply zero transit in some periods. It is understood that the Naftogaz's transportation division, Ukrtransgaz, is using a base scenario of zero transit after 2024.

### *The Ukrainian transport business*

One crucial element that will shape gas transit across Ukraine after 2019 is the reform of Ukrtransgaz, which is now underway as part of a more general energy sector reform. Ukrainian energy law provides for a formal unbundling of Naftogaz's transmission and storage assets to be completed within 30 days of the completion of the Stockholm arbitration case. Nevertheless, major obstacles remain.

The 2014 political and military crisis served as an impetus to energy markets reform. The Law on the Natural Gas Market, which came into force in October 2015,<sup>27</sup> provided for unbundling of transmission, storage, distribution and production activities, along with other measures such as price liberalisation in the retail market and changes to the upstream tax regime. The law also provided for market regulation compliant with the EU third energy package, an objective implicit in Ukraine's membership of the European Energy Community. The international financial institutions, which stepped up their lending to Ukraine after 2014, made the progress of reforms a priority in their negotiations with the government. The Energy Community Secretariat, the EU delegation to Ukraine, and officials of the IMF) and the European Bank for Reconstruction and Development (EBRD) have all monitored the reforms, and been actively involved in drafting secondary legislation and advising on implementation. The Naftogaz management team appointed in 2014, after the change of government, has vigorously advocated for the reforms.

In July 2016, the government, with the international financial institutions' support, issued a decree (no. 496)<sup>28</sup> requiring that Ukrtransgaz's transmission assets be transferred to a new state-owned entity, Main Gas Pipelines of Ukraine (Magistralnyi gazoprovody Ukrainy or MGU), within 30 days of the completion of the arbitration hearings. The decree also required the unbundling of storage, by means of a further government decision. Since the decree was issued, significant differences have emerged between the Ukrainian government and the management of Naftogaz Ukrainy about how unbundling should proceed.

In September 2016, the government ordered that, pending the completion of arbitration, Ukrtransgaz be put under the control of the ministry of economy and trade. This decision was annulled after complaints by, among others, the Energy Community Secretariat.<sup>29</sup> In June 2017, the government approved a list of assets to be transferred to MGU. The energy ministry prepared the appointment of a

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<sup>27</sup> Law of Ukraine On the Natural Gas Market (Kyiv, 2015), especially Articles 20-31 on transmission operator and unbundling.

<sup>28</sup> Cabinet of Ministers of Ukraine Resolution of 1 July 2016. [http://www.naftogaz.com/files/official\\_documents/CMU-unbundling-resolution-No496-ukr-eng.pdf](http://www.naftogaz.com/files/official_documents/CMU-unbundling-resolution-No496-ukr-eng.pdf).

<sup>29</sup> *Interfax/UA Energy*, 7 August 2017. 'Rukovodstvo Naftogaz neobkhodimo izmenit' svoiu politiku'. *Argus FSU Energy*, 22 September 2016. 'Ministry move on Ukrtransgaz reversed'. *Dixi Group*, 19 September 2016. 'Analysis of situation'.

supervisory board for MGU, expected to be announced in March 2018, and also a management team, potentially undermining the principle that MGU should function independently. A draft resolution approved by the government on 1 February 2018 provided for both transmission and storage assets to be transferred to MGU within ten days of the arbitration being completed.<sup>30</sup> Naftogaz managers took a different course of action, commissioning PricewaterhouseCoopers (PwC) to elaborate an unbundling plan, and creating in October 2017 a new subsidiary, Ukraine Gas Transmission System Operator, to manage the transmission system, but not the storage assets.

Both government and Naftogaz hope to involve European companies in the future management of transport and storage. Illusions that were widespread among Ukrainian politicians, that large energy companies could be attracted to invest heavily in the transport system, have dissipated. There are much better prospects for involving European TSOs as partners, with political support from the EU. Under a Memorandum of Understanding signed in April 2017 with Naftogaz and Ukrtransgaz, Snam of Italy and Eustream of Slovakia have produced proposals for unbundling.<sup>31</sup> It is understood that (as of March 2018) these have yet to be presented to the government. Naftogaz management says it is also in talks with other European TSOs about possible cooperation.

Remaining obstacles to successful unbundling were discussed at an industry conference in February. The deputy prime minister, Volodymyr Kistion, reported on the formation of MGU; the government's approach was criticised by Yuri Vitrenko, Naftogaz Ukraine's head of business development, as one that would weaken Naftogaz as a counterparty to Gazprom, and leave distribution assets in the hands of private interests. Most distribution companies are owned by the Firtash group, and remain unreformed. Janos Kopacz, director of the Energy Community Secretariat, stated that: (1) legislation (including amendments to precedent laws) still needed to be adopted; (2) MGU had been incorporated but could not yet be certified; and (3) if unbundling went ahead, but reforms to the retail market, and in particular the phasing-out of Naftogaz Ukraine's public service obligation (PSO) to supply district heating companies and households, did not, Naftogaz would incur heavy financial losses. At present Naftogaz is required under the PSO to supply district heating companies and households at regulated prices, below the market level, whether or not bills are paid. Although the regulated prices came close to import netback level in 2016, rising European gas prices means that they are now substantially below the market level, while non-payment from heating companies is widespread.<sup>32</sup>

The issue of whether or not transportation and storage assets should be unbundled together, or separately, has also been the subject of public controversy. Legal cases have reportedly been brought by Ukrainian business groups in respect of stored gas: from the Kolomoisky group, which is claiming 10.5 bcm of gas in lieu of payment for supply at regulated prices by Ukrnafta, of which the group owns 43 per cent; and from the Firtash group, which is claiming four bcm of gas in respect of a ban from 2014 on supplies from storage to its fertiliser plants. Andriy Kobolev, Naftogaz Ukraine CEO, has argued that this litigation makes the storage assets 'toxic' for potential investors, and that Naftogaz's plan for a 'lean TSO' focused on transportation addresses this issue.<sup>33</sup>

A final reform issue, vital if new transit arrangements are to be made, is the establishment of an independent regulator. Hugues Mingarelli, EC ambassador to Ukraine, stated at the February conference that the Commission was 'extremely frustrated' at the delay in appointing board members for the regulator.

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<sup>30</sup> *ICIS European Gas Markets*, 31 October 2017. 'EGM Focus: Ukraine's TSO unbundling beset by internal disputes'. *Argus FSU Energy* 15 February 2018. 'Gas market unbundling plans move forward'.

<sup>31</sup> *Interfax Ukraine*, 10 April 2017. 'Naftogaz signs memo with Snam and Eustream', <http://en.interfax.com.ua/news/economic/414965.html>.

<sup>32</sup> Author's notes from the Ukraine Energy Forum, Kyiv, 27 February 2018.

<sup>33</sup> *Argus FSU Energy*, 8 February 2018. 'Ukraine unbundling – strings attached'.

It is clear that: (1) the reform is complex because it is, of necessity, interconnected. The issue of cross-subsidy is one example of this. Naftogaz has long been a mechanism for, among other things, using transit revenue to subsidise residential, public sector and district heating customers. Whatever their differences, government, Naftogaz and international organisations agree that such cross-subsidies are unsustainable, and equally that the transition to a market with direct subsidies to poor households (on which they also all agree) will take more time. This is the type of problem that will slow down unbundling; (2) the largest activity of the future transport company, however constituted, will continue to be the transportation of Russian gas to European destinations, at least for the next few years. Once the commercial conditions under which transit will be conducted after 2019 become clearer, so the appropriate shape and size of the new entity may become clearer.

## Conclusions

The Gazprom-Naftogaz arbitration was one of the biggest ever, and arguably confirmed two trends with respect to gas markets. (1) The decision on price, coming on top of other arbitral decisions, was another blow to oil-linked pricing in the European gas market. It confirmed the trend that, even under long-term contracts, prices will increasingly move to those set by the gas market. (2) The decision to leave out of account the legal/regulatory changes in Ukraine also confirms the trend that international contracts supersede EU and national law.

The bigger question is whether, in the end, the parties will accept the arbitral procedure as a means to an end, that is, to putting future relationships on a commercial, rather than political basis.

The arbitral tribunal limited itself to commercial issues, and declined to adjudicate on essentially political questions that underpinned the claims from both sides. For example, Naftogaz's claim that new tariffs should apply from 1 January 2016, and the dispute over the discounts applied to the Ukrainian import price during quasi-political negotiations in 2009-14. While its interpretation of the contracts was quite wide, the tribunal appears to have carefully excluded political and strategic issues from its deliberations. For example, its interpretation of Article 3 of the transit contract, and the payment obligations it implied for Gazprom.

For this reason, it might have been hoped that its decisions would provide the opportunity for agreements on Ukrainian transit after 2019 to be concluded on a commercial basis, despite the state of extreme political hostility between Russia and Ukraine, and the political tensions between Russia and European countries.

Hopes that the conclusion of the arbitration case would allow the companies involved to draw a line under the past, and negotiate commercial arrangements for post-2019 transit, appear not to have been borne out. Gazprom's appeal against the decision is unlikely to produce a substantially different result, and its proceedings for termination of the current contracts is irrelevant to the arbiters' decision. However, these actions will overshadow possible negotiations on post-2019 arrangements. Moreover, during this year and next, while the arbitration appeal is in progress, other crucial issues for Russia's gas trade with Europe will also be in the process of being negotiated including the final outcome of the EU Director General of Competition (DG Comp) investigation into Gazprom pricing, and the legal and regulatory obstacles to the Nord Stream 2 and TurkStream pipelines.

Gazprom's reactions to the tribunal's decision appeared to be a form of protest rather than a way of pursuing a business strategy. Its major European customers may not be unduly concerned. On the other hand, the appearance given, that it was ready both to suspend gas deliveries to Ukraine that were paid for and expected, and to terminate both supply and transit contracts without anything to put in their place, will reinforce political rhetoric in Europe about reducing dependence on Russian gas supplies.

The European Commission after 2014 brokered the arrangement of 'winter packages' that enabled transit and gas supply to Ukraine to continue, despite the political tensions. It may again feel motivated

to intervene, although there is a time constraint, in that the current European Commission's term of office ends on 31 October 2019.

The decline of the Russo-Ukrainian gas relationship will continue. From 2020, transit of Russian gas across Ukraine will continue, but at much lower volumes. Direct sales probably will not. By the mid-2020s, all transit could cease. The only realistic possibilities of this changing depend on an improvement of political relationships, which in turn probably depend on a significant shift in the situation in eastern Ukraine.