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The Role of 'European formulas' in the Russia-Ukraine Gas Debate. Part Three

How modernization of Ukrainian GTS changes the economics of bringing Russian gas to the EU

By Andrey Konoplyanik

As was shown in the first of the two previous articles, Ukrainian factual Euro-integration in gas since 2004 has led to severe economic conflict for the country: import gas pricing based on 'European formulas' has resulted in high import prices for Russian gas which Ukraine considers to be purely politically motivated (EER, June 19, 2014). In the second article, I showed that Ukraine's accession in 2011 to the Energy Community Treaty has created, inter alia, yet to be settled legal problems related to the conflict between contractual and public law within Ukraine: its public law obligation as a result of implementing provisions of the Third EU Energy package to possess reverse flow capacities at its Western borders, conflicts with its earlier contractual law obligation to offtake specific amounts of import gas deliveries from the East according to the Russia-Ukraine 2009-2019 gas supply contract (EER, August 4, 2014). In this article I will address the issue of Ukraine's Euro-integration impact on Russian gas transit to the EU. Ongoing reforms of the management structure of the Ukrainian gas transportation system (UGTS), also resulted from the legal obligation of the Energy Community member states to adapt their energy systems to provisions of the EU energy 'acquis communautaire' (Third EU Energy Package), as well as from the current Ukrainian leadership's implementation of its own "sanctions" against Russia, which can cover energy transit, have been changing comparative economics of Russian gas transit to the EU.


source: Wikipedia

On 8th September the Staff of Verhovnaya Rada (the Ukrainian Parliament) has announced that the President of Ukraine P. Poroshenko has signed the Law N 4116-a "On implementing changes in some laws of Ukraine on reforming management system of the unified GTS of Ukraine" which was adopted in the second reading and in general by Verkhovnaya Rada on 14th August. According to the law, operators of UGTS can be entities established either by Ukraine or the states and/or legal persons of the EU, US or Energy Community member states. As current Prime-Minister A.Yatsenyuk said while presenting the draft Law in the Rada, "GTS will stay 100% in state ownership. The Ukrainian state will hold public tender on attracting investors for modernization and management of the GTS. Investors can only be companies from the EU states and from the US. The operating company (to be created – A.K.) will be controlled by the state: 51% of its stocks will be reserved as state property, and Western companies-investors will receive 49%". The final decision on investor access will be made by the Rada. During the discussions in the Ukrainian Parliament it was said repeatedly that the key issue is to not allow Russian companies access to the management of strategic entities.

At the same day the law "On Sanctions" was adopted which fixed the principal possibility to prohibit transit of Russian gas through Ukraine. The combination of these two laws, together with clarification statements of NAK (Naftogas of Ukraine) made a day before that the companies not under sanctions can undertake transit supplies, could result in, for instance, realizing the long-cherished wish of Ukraine to transfer the existing delivery points of Russian gas from inside of the EU, where they have been located since the first deliveries of gas from the USSR to Western Europe in 1968 until this day, to the Russia-Ukraine border. This means, by default, that transportation of Russian gas through Ukraine and further on towards the EU end-users will be undertaken by non-Russian companies, including transit through EU territory by the newly established operator of UGTS jointly owned by the Ukrainian state, and EU and US

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investors.

But then the natural question arises: whether the Russian state (gas resource owner) and Gazprom (its agent/state company – sole exporter by law of pipeline gas to the EU) will be interested at all in such a model of gas transit to the EU with additional risks and negative economic consequences for the resource owner and the exporter. On top of the already existing risks which have already led to the factual change of export strategy in Russian gas supplies to the EU being based now on the concept of multiple pipelines to each export market (diversification as a risk-management instrument).

If delivery points of Russian gas are to be located at Ukraine's Eastern border, then the title of ownership for gas inside Ukraine's territory is to be moved to its buyer – to the EU companies, Naftogas and/or to the new UGTS management consortium. This would make it automatically possible to implement virtual reverse flows within Ukraine (swap/netting of opposing – from the East and from the West – supplies of gas de facto originating in both cases from Russia) since in such case, after transfer of delivery points to the Eastern border of Ukraine, the title of ownership on Russian gas in Ukraine will not belong to the Russian exporter Gazprom any more. Negative consequences of such netting for the gas resource owner and its marketing agent/exporter (not welcoming any exporter competition of direct and reverse flows of its gas at the same export market) were presented in the previous article (EER, August 4, 2014).

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Furthermore, by such proposed actions Gazprom will be de facto cut off from the supply lines to the final consumers within the EU, i.e. from using one of the potential benefits of the Third EU Energy package for any (including non-EU) gas supplier. The natural aim of Russia/Gazprom (within the possibilities provided by the Third package) is to move its delivery points further on to the West and more deeply within the gas value chains to the EU end-users where the economic rent is higher, - but here it is proposed (by this kind suggestion of Naftogas) to move its delivery points in the opposite direction.

The major aim of the new gas transportation consortium with participation of the EU and US investors (accompanied by a legal prohibition for Russian companies to participate), as was proclaimed multiple times by the current Ukrainian President and Prime Minister, is to modernize and reconstruct UGTS which, they assume, will help improve Ukraine's role as transit state.

Let's put aside the question of how such a prohibition corresponds with Ukraine's participation in the WTO, Energy Charter Treaty and non-discriminative provisions of the EU acquis. Though the latter being violated by the EU legislator itself as, for example, is the case with the Art.11 "Certification in relation to third countries" of the Directive 2009/73/EC. By the way, despite the fact that Art.11 has from the very beginning been entitled by the press as the "anti-Gazprom" clause, in the given case this means that US companies shall be required to pass through this special order as companies from non-EU member states, despite the special privilege given to them (as if on equal footing) by the Ukrainian draft law 4116-a. But the EU laws dominate now, at least in energy, within Ukraine… So, according to Art.11 of the Third EU Gas Directive, US companies cannot be as equal as the companies from the EU in access to shareholding of UGTS.

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Moreover, according to Russian news agency ITAR-TASS, which referred on August 18 to three unnamed sources, three companies including US Chevron plan to apply for participation in the new UGTS consortium. But Chevron has signed on November 5, 2013, a 50-year long production-sharing agreement (PSA) on shale gas development in Olesska area in Ukraine with a total investment, according to previous Ukraine government, of up to 10 billion USD, and with expected gas production of 5 billion cubic meters per year - and possibly as much as 8-10 billion cubic meters. But if so, then there will be a legal problem for Chevron since its plans to become a gas producer in Ukraine will prevent this company to participate in new UGTS consortium (according to EU legislation, the same company cannot be simultaneously a gas producer and transmission system operator – directly, nor through an affiliated company, this is what the Third Gas Directive aimed for). So a lot is still unclear with implementation of this Ukrainian law 4116-a…

Nevertheless, according to Yatsenyuk, the new order of managing UGTS will stipulate Europe's interest to increase gas transit through Ukraine. But "it will not be easy to attract investors", as he acknowledged himself while presenting the law in Rada. And it is not possible to disagree with such statement.

Ukrainian shale gas, in my view, is still an utopia

In order to know how their investments into the modernization and reorganization of the UGTS will be paid back, its potential EU and US stakeholders will want to know clearly what will be the sources of such repayment. The case with the abortive Nabucco gas pipeline is a good illustration for this: even under strong support of the EU authorities, none of the potential shippers (gas producers) have wished to bind themselves to the obligation to supply through that pipeline. As a result, the project stayed as non-implementable since there were no guarantees for its potential investors (Nabucco consortium) of payback of investment which used to be provided by the shippers' advanced capacity bookings and by using the rules "ship-and/or-pay", "use-it-or-loose-it", etc.

There are only two sources of supplies through the UGTS which shall provide such pay back via transportation tariffs: either continuation of Russian gas transit to the EU through Ukraine, or adequate increase of domestic gas production in Ukraine (incl. shale gas) and its supply (export) to the EU. But with or without Chevron's and Shell's PSAs, Ukrainian shale gas, in my view, is still an utopia both in volumes and commencement date (And even the very fact of its occurrence seems rather speculative to me, bear in mind that shale gas projects in Poland that were highly prospective at the initial stage have not materialized in the final instance, though their comparative prospects were much higher than in Ukraine) of commercial production (independent of involvement of the family-members of the first names of US leadership in some projects). Moreover, shale gas is more a domestic, rather than export fuel.

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Domestic onshore and offshore production of 'traditional' gas in Ukraine is also unlikely to be increased significantly – these speculative talks, in my view, were aimed by Ukrainian authorities more on providing a "negotiating effect" on Gazprom in "price review" discussions to persuade it to downgrade export prices in view of (the threats of as if) expected substitution of Russian gas by domestic Ukrainian production from different sources.

So transit remains the only source of paying back for UGTS modernization. But no transit can be continued (enabled) without willingness of the resource owner (or its agent) to supply gas through this or that route if it considers that the risks of such a continuation are becoming too high and/or its economics aren't attractive enough any more.

Any potential transit state stays just as "potential" (not real) a transit area until it creates the stimuli for the producer/exporter to (continue to) supply its gas through this transit state. Until this day Russia is the only such producer/exporter for Ukraine: Central Asia has long ago reoriented its gas flows to China (backed up by discounted and tied Chinese loans), while the EU, in its endeavours to bring Central Asian gas to the EU market, has first lost the time in the fight (also lost) with Russia aimed at gaining access to Russian GTS at domestic and discounted Gazprom's internal transportation tariffs, and then in the intention (also non-implemented) to bring Turkmen gas into the Nabucco project, while without this gas the entire project went dead.

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In international economic relations it is not possible to force an exporter to supply its gas through this or that route – one can only incentivize him to do so. But the risks of gas supplies to Ukraine and through Ukraine have been growing. This has led to the diminishing economic interest of Russia and Gazprom to continue its gas transit via Ukraine and has incentivized both the resource owning state (Russia) and its exporting agent (Gazprom) even more to search for and develop by-passing routes to the EU. This is why Russia and Gazprom are looking for diversification of its export routes to the markets as a means to diminish its transit risks which have been increasing of late due to increasing claims of the current political authorities of Ukraine to change the existing gas transit schemes to the EU.

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