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Oil, Gas & Energy Law Intelligence

The Gas Transportation System of Ukraine and Russia Has Always Been Unified (Interview)

by A. Konoplyanik

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Andrey Konoplyanik:

“The gas transportation system of Ukraine and Russia has always been unified”

24 December 2008 - In the winter of 2005-2006, Andrey Konoplyanik, as Deputy Secretary General of the Energy Charter Secretariat in Brussels, was involved in settling a gas dispute between Moscow and Kiev. In an interview with Economic News (EN), he talked about how this time Gazprom and Naftogaz of Ukraine might find mutual understanding, so that the companies fulfill their obligations for continuous gas supplies to European consumers.

Andrey Alexandrovich Konoplyanik received an education and defended dissertations for the PhD (Economics) (1978) and Doctor of Economics (1995), both in international energy economics, at Moscow State Academy of Management. From 1991 to 1993, he was Russia's Deputy Ministry of Fuel and Energy responsible for Foreign Economic Relations and Direct Foreign Investments. He was involved in developing Russia's Energy Strategy to 2020. He headed a group of drafters of the legislation on production-sharing agreements under the State Duma. From March 2002 through May 2008, he was Deputy Secretary General of the Energy Charter Secretariat in Brussels. He is currently an advisor to the Board of Gazprombank (Moscow). He is a member of the International Bar Association, the International Association for Energy Economics, and the Association of International Petroleum Negotiators.

Question: Gazprom and Naftogaz of Ukraine have by no means settled the question of servicing debt for gas supplies to Ukraine and determining the price of supplies in 2009. How high is the probability of a repeat of the situation where the companies start the new year without concluding any commercial contracts?

Answer: I don't want to estimate the probability in percent, but in theory it exists. But I really hope this won't happen. Whatever we say about the politicians in any country, no matter how we criticize them, people learn from their mistakes. Everyone should understand that the lack of a concluded contract is of no advantage to anyone. The consequences of failing to conclude a contract have only a negative effect on both parties. In this situation, the only politician who wins will be the one betting on worsening relations between Ukraine and Russia.

Although they are sovereign states, our countries are so interconnected economically that strengthening the economic basis of their effective cooperation must be the dominant economic line of any Russian politician — pro-Russian — and any Ukrainian politician — pro-Ukrainian. This is in the long-term economic interests of Ukraine and Russia and of any

policy-maker who is not a short-term wire-puller. Moscow and Kiev have experience in finding balanced solutions on critical issues. In particular, the memorandum on gas of October 2, 2008, shows that the parties have already found a mechanism that doesn't require reinventing the wheel: this is the European formulas we were talking about in the first part of the interview (see EN No. 212 of November 24 of this year). They give approximate guidelines for what contract prices should be under market conditions, i.e., when they are calculated according to a formula linked to the replacement value of energy resources that are alternatives for gas for end-users in Europe.

However, there was an agreement on a three-year transition period. The issue in the current discussion concerns a reduction factor that will provide for a gradual increase in the price of gas to market level, while the reduction of this same "market level" begins in 2009. It's extremely important to understand that the "market level" of gas contract prices is not a constant parameter. It is the result of the operation of a price formula, and so is subject to fluctuations, even if smoothed. Today, gas contract prices are on the point of falling. And as usually happens in contracts with European pricing formulas, they will head downwards with a nine-month lag following the drop in oil price in the fall of 2008 as well as the prices of gasoil/diesel and residual fuel oil, which are key components of gas price formation in Russian long-term gas supply contracts to Europe.

Thus, we are not facing the situation at the start of 2006, when there was a need to find a price mechanism and a supply scheme to support it that would help to reach an acceptable, but still, let's say, "quasi-market" gas price level for Ukrainian consumers. At that time such supply scheme turned out to be with a middleman.

Question: What was the distinctive feature of the gas dispute between Moscow and Kiev in the winter of 2005-2006?

Answer: The parties needed to find a mutually acceptable solution for integrating two fundamentally different export gas pricing methodologies for the two main gas streams originating outside Ukraine and arriving in its territory and/or in transit through Ukraine.

On the one hand, you have gas originated from Central Asian producing states (Turkmenistan, Uzbekistan, Kazakhstan), which until 2009 will be priced according to the "costs-plus" formula at the border of the exporting country (plus a negotiated premium) plus the transportation costs to the Russian-Ukrainian border. On the other hand, you have gas originated from Russia, which since 2006 was priced according to its "replacement value" at the European market minus the transportation cost (netted-back) to the Russian-Ukrainian border.

This solution had to be found first in the practice of the countries' mutual relations and on a tight schedule. The fact that the parties were able to find such a workable solution under very stressful conditions is to their enormous credit.

There is still a probability of lost contracts

QUESTION: What is the task facing Gazprom and Naftogaz of Ukraine today with respect to price formation?

ANSWER: An easier one than at the end of 2005. They need to find a mutually acceptable solution within the framework of a single price formation methodology (since January of 2009) for gas originated from Russia and Central Asian states. Unfortunately, there is still a probability of lost contracts. This is connected with possible breakdowns in political stability. But I don't want to speculate on this topic. The important thing is that the people making the decisions have the authority to conduct gas negotiations and sign contracts. And have the same understanding of how gas export price formation mechanisms work. Then there is the question of coupling the use of the chosen pricing formula and the need to reimburse the accumulated debt for gas. In other words, the conditions for implementing (starting operation) of the price agreement reached.

QUESTION: It's said that Gazprom can't cut the gas supply to Ukrainian consumers. How adequate and realistic can Gazprom's actions be if contracts with Naftogaz of Ukraine for 2009 aren't signed by January 1?

ANSWER: The gas transport system (GTS) of Ukraine and Russia has always been unified — there are no separate pipelines for transit and for export supplies to the Ukrainian market. When gas goes through the GTS for domestic consumption in Ukraine and then by transit to the EU, these streams can be separated contractually but not physically. These are gas streams that flow through a common pipeline. So when people talk about shutting off supplies (I don't think anyone really wants this to happen), this implies shutting off supplies to consumers in Ukraine, but they continue in transit. There is no way to separate gas molecules that go for consumption in Ukraine and those that pass through Ukrainian territory to third countries; you can't raise a Chinese Wall between them. They can be separated only by legal mechanisms.

If there are two contracts — for supply and transit — you have separated these streams contractually, you have legally separated the obligations for supplying volumes of gas to various consumers. If there are signed long-term contracts to supply third countries, which are backed by transit contracts with a given transit country, these gas streams must be pumped. These are legal obligations that are specifically interpreted as “firm” in Art. 7 of the Energy Charter Treaty (ECT). In other words, under international law, these obligations must be fulfilled whatever the case, and the transit country does not have the right to disrupt or reduce existing transit.

The transit country has the legal responsibility to guarantee continuous transit if the corresponding ECT member countries bring up this question. Consumer countries that have received less than these gas volumes due to transit reductions have the right under the ECT to file suits against the transit country in international arbitration.

QUESTION: What is the role of international arbitration in settling such a dispute?

ANSWER: It can determine the damage caused in cash that will be recovered, because the claim settlement system is also quite well spelled out there. But I don't think any country, especially one that is not in a very stable financial situation, and especially in the current financial crisis, needs additional risks and expenses.

If a contract is not signed by 24.00 on December 31, 2008, at 00.00 on January 1, 2009, Gazprom will have no legal grounds for exporting gas supplies for domestic consumption in Ukraine.

Tariffs should not be compensatory

QUESTION: How can the Energy Charter Secretariat (ECS) influence settlement of the conflict between Gazprom and Naftogaz of Ukraine?

ANSWER: Along with the ECS, there are several general solutions that impede the threat of a disruption of transit and gas supplies to the transit country. In the traditional long-term contracts under which all of continental Europe operates, there is a gas price formula that is regularly revised. It has a built-in mechanism whereby if the parties hold negotiations on revising the price formula or price level, the previous price remains in effect during the negotiations and the previously signed contract continues to operate. After an agreement on a new price is reached, payments are recalculated — from the date agreed by the parties, for example, from the date one of the parties declares the need to adjust the price. The main principle here is to ensure continuity of the contract and a stable energy supply. In this case, the burden of proof is on the party that initiated the revision. Thus, the problem of disagreement on price and continuity of supplies is quite easily solved by moving to a long-term contract scheme in the relations between countries. That is, Gazprom and Naftogaz of Ukraine need to switch to a long-term contract model.

QUESTION: What about determining the transit tariff?

ANSWER: After Ukraine and Russia have separated export and transit streams, export deliveries and transit deliveries can be made within the framework of long-term contracts that in essence are similar. They must make provision for a mechanism guaranteeing continuity of supplies with the possibility of regular, justified revisions of prices and tariffs.

During negotiations over long-term transit contracts, not only the possibility of revising transit tariffs needs to be specified, but also the time, criteria, and procedure for revisions. This will provide a means of maintaining stable transit streams and make the transit tariff adjustment mechanism transparent and predictable.

The question of the transit country's income from gas transit is of no concern to consumers in Europe. Commercial entities, in this case Gazprom and Naftogaz of Ukraine, must discuss the question of transit tariffs. Substantiation and justification of their economic arguments and communality of approaches to determining tariff levels play a key role here.

It should be remembered that the gas export price level, which is linked to the replacement values, is a much more flexible quantity than the transit tariff level, which reflects payments

for gas transportation operations (the 51 ECT countries have tentatively agreed in the draft of the so-called Transit Protocol that transit tariffs are to be cost-based and incorporate investment and operating costs, including a reasonable rate of return). Therefore, the transit tariff level can be set for a longer period than the gas export price level.

QUESTION: If the companies cannot agree, how will they settle the dispute out of court?

ANSWER: There is an intermediate mechanism for finding a solution out of court. The ECT makes provision for a so-called conciliation procedure to settle transit disputes. This is a milder form, where a neutral conciliator is called upon to settle a transit dispute jointly with the parties. This is the ECS's potential contribution to resolving any transit disputes where the parties cannot reach an agreement with one another without involving a third person.

QUESTION: Can the ECS prevent gas disputes from occurring?

ANSWER: This is a longer-term component of the Secretariat's work. Most recent disputes have been caused by a lack of transparency and equal understanding not only in Russia and Ukraine, but also in the international community of both physical volumes of gas streams entering and leaving Ukraine and the price and tariff formation methodologies for various components of these streams. These components include: exports to Ukraine, transit through Ukraine, and the use of underground gas storage facilities in Ukraine, including in the interests of guaranteeing continuous transit.

The Secretariat is working for greater transparency in these matters. A study of the transit tariff formation methodology was prepared in 2005. It was published in January of 2006, but we sent the unpublished version to the Russian and Ukrainian sides during their gas dispute in the winter of 2005-2006; and as far as I know, this study sat on the tables of the parties' negotiating delegations, who actively used it as an argument base to bring their positions closer together.

In 2007, we published a study of international oil and gas price formation mechanisms, which described in detail the mechanisms of the European formulas for determining gas prices in the contracts predominating in Europe.

Before my contract with the ECS ended, we also started similar work on questions of the formation of underground gas storage tariffs. Ukraine was the proforma initiator of this study and even reinforced it with its own personnel — it sent a secondee (temporary employee) to ECS, as well as Russia, to work on this topic.

So I hope that all interested parties understand that although exports to Ukraine, transit through Ukraine, and the use of Ukraine's underground gas storage facilities in the interests of transit are three facets of one process of transporting gas through Ukraine from east to west resulting from the specific architecture of Ukraine's gas transport system (GTS), prices and tariffs for each component of these streams must be formed separately, and not according to the compensatory principle often heard from representatives of the political establishment: they say that if gas import prices for Ukraine increase, it will compensate for the increase with a sufficient increase in transit tariffs and/or tariffs for the use of underground gas storage facilities.

In the fall of 2006, the Secretariat came out with a new initiative, which is currently underway, to provide reasonably sufficient transparency of gas stream volumes at key points of the trans-border gas supply chains along their entire length within the ECT zone, extending to the East the practice of information openness existing in the EU within the framework of “Gas Infrastructure Europe”.

The parties must change the date for concluding contracts

QUESTION: How did the ECS interpret the Ukrainian–Russian gas dispute at the beginning of 2006, and what did the Secretariat do to settle it?

ANSWER: The ECS offered its services as a third party in settling the dispute. The Secretariat went on holidays on December 20. During this period in 2005, the discussion between Moscow and Kiev was heating up. Furthermore, this was a situation where the term of one Secretary General had de facto ended on December 16, and the newly elected Secretary General was due to take office formally only on January 1 (and de facto on January 3 since January 1 was Sunday). Therefore, the acting Secretary General for this period was your humble servant. But we weren’t in the office because of the holidays. Nevertheless, the ECS contributed its share. On the first workday, January 3, the new Secretary General sent letters to Ukraine and Russia to the authorized government departments: to the Ministers of fuel and energy of both countries, and to the Heads of Management Boards of Gazprom and Naftogaz of Ukraine (and has informed about this the EU Commission and the EU Presidency as the third party de facto involved). In the letters, the Secretariat proposed that the parties use the conciliation procedure provided in the ECT for settling transit disputes if they so wished. Even though we were on holidays, we did everything possible in advance so that the procedure could be launched immediately. In particular, we agreed with the Ukrainian and Russian sides on potential candidate for conciliator; i.e., the person who would participate in this capacity was approved in both Moscow and Kiev.

QUESTION: Who was it?

ANSWER: With your permission, I won’t give his last name, since he might be called on again this year. Last week, the Secretariat, as in the winter of 2005-2006, once again drew the attention of the parties to the ECT provisions concerning the inadmissibility of disrupting transit streams and its willingness, if necessary, to arrange a conciliation procedure to settle transit disputes. This time again, just like three years ago, my colleagues at the Secretariat have already obtained the agreement of the same potential conciliator (whose candidacy was already approved by Russia and Ukraine at that time) to settle the dispute in the present situation should it become necessary.

At the beginning of 2006, the Secretary General’s offer was not taken up, because Gazprom and Naftogaz of Ukraine concluded a bilateral agreement on January 4. I think the fact that the companies were able to arrive bilaterally at a gas supply scheme in effect until 2009 is better than if the parties had been forced to resort to the services of a conciliator.

QUESTION: Why better?

ANSWER: Because otherwise Ukraine and Russia would have shown to the whole world that they were incapable of reaching an agreement with one another. In the long term, this

would have had a strong negative effect and would have given grounds for detractors, who were trying to gain from driving various wedges between our countries, to reproach us for being so different that we weren't able — and would never be able — to agree.

In March of this year (2008), I was invited to Harvard University to speak on the issue of Ukrainian-Russian gas relations. To all appearances, I was the only person prepared to explore the economic rationality of the changes that had taken place. After listening to the speakers on the first day, I began my presentation on the second day of the event with the words: "If someone who didn't know the essence of the events taking place between Russia and Ukraine over gas had been present at our event and had listened to the presentations on the first day, he would have formed the impression that the driving force of Ukrainian-Russian gas relations was the incompetence of the people making the decisions, all kinds of phobias (Russophobia, Ukrainophobia, Putinophobia, Timoshenkophobia...), and corruption. Whatever you like, except economic rationality and common sense."

Naturally, Gazprom and Naftogaz of Ukraine are not going to make the transition to smooth market relations immediately. But I'm assuming that the actions at Naftogaz of Ukraine and Gazprom and in the departments of energy and governments of both countries are aimed at finding balanced, operative mechanisms. So far, this search has largely been proceeding intuitively. But intuition is increasingly based on economic realities taken from European and Russian practice that provide a means of gradually decreasing risk and errors and gradually increasing the rate of finding balanced solutions.

And it seems to me that the parties would have been right to change the date for concluding contracts from January 1 at the peak winter demand period for gas, not even to October 1, as is done in Western Europe, but let's say to summer, when there is a seasonal drop in demand for gas.

Conversation with Svetlana Dolinichuk, 24 December 2008

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