Modernisation of Ukraine’s natural gas transportation system: Ukraine as an energy hostage syndrome

Vytautas Sirijos Gira

On August 25th the current year Ukrainian Prime Minister Mykola Azarov declared that Ukraine should review its agreement with Russia made on January 19, 2009, regarding natural gas prices for 2009-2010. In Azarov's opinion, Russia's present prices for natural gas are too high and do not meet Ukraine's interests even taking into consideration the discounts offered by Russia. According to Azarov, if the price for 1000 cubic meters of Russian natural gas sold to Ukraine exceeded $390 US, the economy of the country would collapse (to compare: currently Germany pays Russia US $308 per 1000 cubic meters of Russian natural gas). The statement by Ukrainian Prime Minister as well as the attempts, which have intensified over the past few months, by the new Ukrainian government (regarded by the West as pro-Russian) to review energy relations with Russia, raise the question about the reasons that brought about the tension in the bilateral energy relations between Ukraine and Russia. Is Ukraine's wish to review energy relations with Russia at all feasible in the short- and mid-term perspectives? How can Ukraine's development be affected by the increasingly active involvement of the EU in the changing Ukraine-Russia energy relations?

In the third quarter of 2010 (with Russia's 30 per cent discount, documented in the 2010 Kharkov Agreements, applied) Ukraine paid US$ 248 for 1000 cubic meters of natural gas. – Author's note.
The development of Ukraine-Russia energy relations

Aspirations of the Ukrainian government to review energy relations with Russia may be explained by the wish to obtain additional leverage in the negotiation process on modernisation and privatisation issues of the Ukrainian natural gas transportation system. As Russia intends to make the South Stream gas pipeline operational from 2015, Ukraine would lose its role as a major state transporting Russian natural gas (presently 80 per cent of Russian natural gas intended for European countries is transported through the Ukrainian territory). Although it would be significantly cheaper for Russia to transport natural gas via Ukraine than through the South Stream gas pipeline, it is nevertheless inclined to direct the transit of natural gas through the South Stream gas pipeline in the nearest future, even if Ukraine allowed Russia to privatize the natural gas transportation system. In other words, seeking to have control over Ukraine’s energy infrastructure, Russia is prone to focus primarily on political, rather than economic, logic. One should emphasize that Russia’s energy pressure on Ukraine is indirectly intensified by the European Union (EU) itself. The negotiations between Ukraine and the EU regarding modernisation of Ukraine’s natural gas transportation system, which have been ongoing since March 2009, have increased the opportunities for Russia’s capital to privatize Ukraine’s energy infrastructure. For instance, on July 8 the current year the Ukrainian parliament passed a law liberalizing the natural gas market, which from 2012 onwards envisages separation of natural gas companies according to the sphere of activity (natural gas mining, transportation and sale). The law was adopted as Kyiv sought to receive support from the EU for the modernisation of the natural gas transportation system, while passing this law prepared grounds for Ukraine to join Europe’s Energy Community. On September 24, 2010, Ukraine’s fuel and energy minister Yuriy Boyko signed the Protocol on the Accession of Ukraine into Europe’s Energy Community (to come into force the Protocol has to be ratified by the Ukrainian parliament). On the

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2 Ukraine’s natural gas transportation system comprises 37,500 km of gas pipelines, 71 booster stations and 13 underground natural gas storage units with up to 32 bln cubic meters capacity. European countries receive annually 141 bln cubic meters of natural gas delivered through Ukraine’s natural gas transport system. The energy infrastructure used to export energy sources to the West is documented in Ukrainian laws under national objects of strategic importance prohibited for privatization – Ukraine Business Online, ”Ukraine – EU agree cooperation on modernisation of Ukraine’s pipeline system”. <http://www.ukrainebusiness.com.ua/news/1761/Ukraine-EU-agree-cooperation-on-modernisation-of-Ukraines-pipeline-system.html>

3 To compare: The expenditure of the modernisation of Ukraine’s natural gas transport system would amount to US $6,5bln, while the implementation of Russia’s South Stream project – US $28-36bln. – Author’s note.

4 European Energy Community, also known as dar Energy Community of South East Europe or just Energy Community was established by the EU and third countries in October 2005, thus expanding EU internal market to the neighbouring countries of South East Europe as well as other countries. The full members of this Community are EU states, Albania, Bosnia and
hand, the new Ukrainian natural gas market liberalization law is favourable to
Russia's natural gas company Gazprom. The aforementioned law envisages
separation of Naftogaz daughter companies Ukrtransgaz, Gaz Ukrainy and
Ukrrgazdobycha, while commercial companies (including foreign ones) will
receive direct access to Ukraine's gas pipes and underground natural gas
storages. It should be emphasized that in this case GazpromSbyt-Ukraina, one
of the daughter companies of Russia's natural gas company Gazprom, would
receive unlimited opportunities for expansion in the Ukrainian natural gas
market. Until now the GazpromSbyt-Ukraina has operated in the Ukrainian
natural gas market according to certain contractual principles: the company
would purchase from the Naftogaz 10 per cent of all natural gas available in the
Ukrainian market and would later resell it to the narrow range of industrial
users. In other words, the GazpromSbyt-Ukraina has essentially performed the
functions of a natural gas supply operator. When the new Ukrainian natural gas
market liberalization law has come into effect in 2012, GazpromSbyt-Ukraina
would not only get the opportunity to occupy Ukraine's entire natural gas
market, but would also provide Russia's natural gas company Gazprom a chance
to have direct control over Ukraine's industry sector and to obtain a monopoly
access to the Ukrainian natural gas underground storages and transportation
system.

Pursuing a review of unfavourable energy agreements with Russia and
attempting to intensify bilateral energy relations with the EU, at present
Ukraine may be referred to as a state which has come to an energy deadlock.
The agreements which Ukraine signed with Russia in 2009-2010 essentially laid
ground for the subsequent energy integration with Russia and fastened a
number of safety locks which are limiting Ukraine's opportunities in upgrading
its energy infrastructure without Russia's participation. Seeking to assess what
influence the 2009-2010 natural gas agreements between Ukraine and Russia
have had on Ukraine one should provide an overview of their principal
provisions (see Table 1):
Table 1. Influence on Ukraine of 2009–2010 agreements between Ukraine and Russia on natural gas provisions

<table>
<thead>
<tr>
<th>Agreement between Ukraine and Russia</th>
<th>Positive influence on Ukraine</th>
<th>Negative influence on Ukraine</th>
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<td>Agreement between Ukraine and Russia on the contract for natural gas supply to Ukraine in 2009-2019 made on January 19, 2009.</td>
<td>The non-transparent mediation scheme was abandoned (mediation services of RosUkrEnergo) which had been the basis for the bilateral energy relations between Ukraine and Russia since 2004. The price formula of Ukraine's imported natural gas came to be linked with European prices of energy sources. In March 2009 the provisions of the aforementioned agreement encouraged the EU to initiate negotiations on the modernisation of Ukraine's natural gas transportation system (on March 23, 2009 the EK and Ukraine signed a joint declaration on this issue) and enhanced Ukraine’s financial image at the International Monetary Fund (IMF).</td>
<td>The agreement envisages a steady increase in the price of Russia's natural gas sold to Ukraine to take place once per three months. In the beginning of 2010 Ukraine paid Russia US $330 for 1000 cubic meters of natural gas (with Russia's 30 per cent discount, established during the 2010 Kharkov Agreements, the actual price for natural gas constituted US $236 for 1000 cubic meters). To compare: in 2008 Ukraine paid US $180 for 1000 cubic meters of gas, while by the end of 2010 the price for Russian natural gas should amount to US$390 for 1000 cubic meters margin (that is, even after the discount has been applied the price will exceed US $250 for 1000 cubic meters margin).</td>
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It should be emphasized that the increase in Russia's prices for sellable natural gas was connected with fixing taxes for the transit of natural gas through Ukraine's territory (the size of taxes fluctuated from 1/3 to 0.5 of corresponding taxes in European states; however, it could not be higher). The leap in Russia's prices for the supplied natural gas significantly contributed to Ukraine's economic recession and in Autumn 2009 encouraged Ukrainian government to start looking for new possibilities of agreement with Russia.

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<th>Agreement between Ukraine and Russia on natural gas supply made on November 19, 2009.</th>
<th>Unfavourable terms of the agreement and the beginning of Ukraine's presidential election campaign made Ukrainian government review the provisions of an earlier agreement with Russia. In the agreement of November 19, 2009, Ukraine and Russia agreed on the suspension of Gazprom's provision „take or pay“6 and a 60 per cent increase in the fixed tax on the transit of natural gas through Ukrainian territory.</th>
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| Kharkov Agreements of April 21, 2010. | According to these agreements, Russia gave a 30 per cent discount to Ukraine for the period of ten years for the present price of natural gas (however, the discount is not to exceed US $100 discount per 1000 cubic meters of natural gas). The discount was provided in exchange for the right for presence of the Russian Black See fleet in the Ukrainian territory (Sevastopol's Port) until 2042. It is forecasted that the Kharkov Agreement neutralized Ukraine's opportunities to use the revision of the rental agreement on the Russian Black Sea Fleet base in Sevastopol's Port as a lever with respect to Russia. The Kharkov Agreements envisage that any review of the rental agreement on the |

6 “Take or pay” is a provision frequently applied in Gazprom's practices when making agreements with natural gas buyers. According to this provision, the natural gas buyer assumes the obligation to pay for the agreed purchased amount of natural gas even if a lesser amount was bought or the party withdrew from the agreement. – Author's note.
Agreements will have stabilizing impact on Ukraine and will allow it to save US $40 bln in the ten-year period.

Russian Black Sea Fleet will cancel the aforementioned 30 per cent discount for the natural gas price, while Ukraine will have to return the money saved to Russia

According to the Kharkov Agreements, the 30 per cent discount will be applied only on condition that the present natural gas price formula (according to which the natural gas price is linked with changes in the global petroleum products) shall not be modified. By demanding a review of natural gas prices Ukraine may lose the relevant discount.

The Kharkov Agreements foresee that in accordance with the agreement made on January 19, 2009 the aforementioned provision „take or pay” remains in effect in the Ukraine-Russia energy relations. In addition, the provision introduced by the November 19, 2009 agreement on the 60 % tax increase for the transit of natural gas through the Ukrainian territory was withdrawn, i.e., a return was made toward the fixed taxes on transit foreseen by the January 19, 2009 agreement.

The Kharkov Agreements turned pointless Ukraine’s accession to the European Energy Community Treaty and postponed its prospects for NATO-membership until at least 2042.

The Kharkov Agreements allowed Russia to keep making plans for taking over Ukraine’s energy and strategic industrial sectors. For example, on May 17, 2010 Russia’s President Dmitry Medvedev offered Ukraine to synchronize the
development of socio-economic relations of both countries. This suggestion referred to setting up joint ventures with Ukraine in the industrial sectors of natural gas, steel, chemistry, aviation, nuclear energy and shipbuilding.

The synchronization initiative suggested by Russia may also refer to the already mentioned Gazprom-Naftogaz merger proposal by Russia’s Prime Minister Vladimir Putin made on April 30, 2010, in which Naftogaz of Ukraine would hold 5-10 per cent of shares. Russia’s promulgated synchronization of socio-economic relations with Ukraine has put heavy pressure of Russian investors on Ukraine’s strategically important industrial sectors. This prompted the new pro-Russian Ukrainian government to oppose projects having to do with closer integration with Russia and to seek counterbalance in the West.


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Scenarios for Ukraine's energy relations with Russia and EU

It may be maintained that currently the vacuum formed in the energy relations between Ukraine and the West, has effectively been filled by Russia, which through 2009-2010 agreements limited Ukraine's opportunities for political and economic maneuvering. Given the present situation, experts distinguish at least three scenarios for possible further development of Ukraine's relations with Russia and the West:

**The Deadlock Scenario.** The present natural gas agreements between Ukraine and Russia will not be revisited, while Russia will continue to implement projects on various energy connections bypassing Ukraine (to these one may also attribute the already operating Yamal-Europe, Blue Stream as well as the planned South Stream and North Stream gas pipelines). Ukraine's economic and political instability will grow; therefore, if Ukraine keeps opposing Russia's intentions to take over control of the energy infrastructure of the country, it will be forced to review its economic model. Ukraine's industrial sectors of agriculture, nonferrous metals and steel will become cornerstones of the country's economy. In pursuit of absolute control over Ukraine's economy, Russia will keep enforcing the synchronization initiative of socio-economic relations with Ukraine, and the pressure of Russian investors on these sectors of Ukraine's economy will keep growing. It is likely that, due to Russia's increasing economic and political pressure, Ukraine will be forced to shed further plans on its integration into the EU and rather integrate into Russia's currently developed projects in the space of the Commonwealth of Independent States, e.g., the Customs Union or the Single Economic Space Union. It must be emphasized that the fulfillment of this scenario is hardly possible in the short-term perspective, as in the nearest 5-10 years Ukraine should remain the main state for transit of Russian energy sources.

**Tripartite/multilateral consortium scenario.** Currently Ukraine relates the modernisation issue of Ukrainian natural gas transportation system to a tripartite/multilateral consortium formed by the EU, Russia and Ukraine. The establishment of the consortium would prepare ground for Russia to abandon the costly South Stream project, while Ukraine would be able to review the unfavourable bilateral agreement with Russia on the terms for natural gas supply signed on January 19, 2009. On the one hand, setting up the consortium would allow Ukraine to reduce energy dependence on Russia and its promoted various models of bilateral integration, such as joining Gazprom and Naftogaz of Ukraine, or other schemes enhancing the melting of Ukraine's energy sector.

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in Russia’s energy sector. On the other hand, the creation of a consortium that would comprise Naftogaz of Ukraine, Gazprom and one or several energy companies of EU states would allow Ukraine to balance between Russia and the West without resorting to more profound integration models with Russia or the West. The success of implementing a tripartite consortium would depend on the significance of Ukraine itself in the would-be consortium. At least several examples of the likely agreement on the structure of a tripartite consortium may be distinguished:

- Ukraine could sell its natural gas transportation system (or part of it) to the consortium and use the funds received to implement structural reforms which are important for the state. However, in this case Ukraine would have to abandon partial or entire control over the natural gas transportation system. This is hardly possible since Ukrainian laws assign energy infrastructure used to export energy sources to the West as strategically important national objects prohibited for privatization.

- Ukraine could give on operator's rights the natural gas transportation system for a long-term rent to the consortium on condition that it will take care of the system and will modernize it.

- For a certain fee Ukraine would delegate the rights to use natural gas transportation system to the consortium; however, it would retain its obligations to upgrade it.

It should be emphasized that the tripartite/multilateral consortium scenario may include miscellaneous versions of setting up a consortium. For example, Ukrainian, Russian and the EU companies could have equal rights in taking part in the consortium's activities (each would have 30 per cent of the consortium's shares), concurrently involving an international financial institution which would hold 10 per cent of the consortium's shares and which would perform the functions of an impartial arbiter. In addition, Ukraine may decide on an alternative tripartite / multilateral consortium model, in which Ukrainian and Russian companies would be the main partners, while companies of European states, for example, Germany, would enjoy the role of a junior partner. The alternative tripartite/multilateral consortium would enable Ukraine to preserve the scope of collaboration with Russia without making changes in the current legal framework or economy structure; however, it is likely that in the medium- and long turn Russia will be increasing its pressure in pursuit of privatization of Ukraine’s natural gas transportation system.

The fulfillment of this scenario should be related to changes in Ukraine’s legal framework which prohibits privatization of natural gas distribution network

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and appreciation of the threat that the disagreements which have emerged between Ukraine and Russia might turn into bilateral relations between Ukraine and the EU as well as Russia and the EU.

Table 2. The stances of Ukraine and Russia on forming a consortium

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<th>Ukraine's stance</th>
<th>Russia's stance</th>
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<td>A multilateral consortium is important to Ukraine primarily seeking to ensure both modernization of its natural gas transportation system and the scope of the transported Russian gas (it is expected that upon modernizing Ukraine's natural gas transportation system the yearly flow of transported gas would grow from 120 to 200 bln. cubic meters).</td>
<td>Seeking to take over the control of Ukraine’s natural gas transportation system, to a certain extent Russia is interested in forming a tripartite / multilateral consortium, yet it does not associate it with any possible discounts or review of energy relations with Ukraine or projects dealing with gas pipeline bypassing Ukraine (South Stream, Nord Stream). In pursuit of control over Ukraine’s natural gas transportation system in 2002-2010 Russia's government at first (prior to the so-called Kharkov Agreements) advocated the idea of forming a tripartite consortium between Ukraine, Russia and Germany, making connections with the privatization of Ukraine’s energy infrastructure. In late April 2010, when Russia’s Prime Minister Vladimir Putin had suggested that companies Naftogaz of Ukraine and Gazprom be merged, the idea of forming a tripartite/multilateral consortium became a project of secondary importance to Russia and relevant discussions were temporarily frozen. This is also testified by Russia's intentions to assimilate the price of natural gas delivered to Ukraine with that of domestic sales if Ukraine gave its consent to form a joint venture between its natural gas distribution company Naftogaz of Ukraine and Russia’s Gazprom. In Russia’s opinion, this project would be mutually beneficial: the Ukrainian side would be able to buy gas at a 1.5 times cheaper price (i.e. at Russian domestic price); in addition, a common Russian-Ukrainian resource base would be formed.</td>
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<td>The establishment of a multilateral consortium is grounded on Ukraine's chances to retain its natural gas transportation system in the nearest future and the assumption that it will allow Ukraine to review the unfavourable bilateral agreements with Russia on natural gas supply.</td>
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<td>Ukraine sees the formation of a multilateral consortium as a peculiar alternative to Russia's implemented Nord Stream and South Stream gas pipeline projects. Ukrainian experts maintain that, regardless of whether Russia will succeed in implementing the aforementioned projects or not, at least until the year 2020 Ukraine is to retain the role of the main transit state which transports Russia’s energy sources to Europe.</td>
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Despite the negative factors listed above (controversial stances of Ukraine and Russia with respect to the tripartite/multilateral consortium, Russia's energy pressure on Ukraine, et.al.), in the opinion of Western experts10, the EU should

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abandon its passive standpoint on the issue of the formation of a tripartite/multilateral consortium and involve actively into its formation process due to the following reasons:

– The mechanism for forming a consortium is fairly transparent and clear, while the countries implementing this project would essentially have to agree only on partial property (dividing the share block) issues. Taking this into consideration, the financing of the project could be ensured by the European Bank for Reconstruction and Development (EBRD) or the European Investment Bank (EIB) together with the Russian Gazprom and several other European energy source companies.

– Forming a consortium would enhance EU energy security. It would enable political, technical and legal separation of the operation of the natural gas transit system from Ukraine’s domestic natural gas distribution market and thus protect itself from the yearly consequences arising due to natural gas wars between Ukraine and Russia (cutoff of natural gas) to all European states. In addition, the consortium (depending on the nature of the outcome) could renew the EU-Russia dialogue on the European Energy Charter Treaty and its ratification of its Transit Protocol. The ratification of these documents would enhance the independent and objective mechanism for dispute resolution which would enable Russia to seek compensation should Ukraine did not pay for the natural gas bought from Russia or appropriate flows of Russian natural gas exported to Europe.

– EU involvement in the formation of a tripartite / multilateral consortium would demonstrate EU opportunities for prompt response to strategic initiatives enhancing the efficiency of EU foreign and security policy in the Russian neighbourhood space.

– Finally, it would create a peculiar synergy between the EU and Russia's East neighbourhood policy space, Ukraine remaining to be at its core. The formation of a consortium would allow decrease in competitive pressure due to the division of influence zones between the EU and Russia.

It should be pointed out that the EU, which for the time being is passively reacting to Ukraine’s suggestions regarding the formation of a tripartite / multilateral consortium or the merger of Ukrainian and Russian natural gas companies, is not prone to discard totally the idea of multilateral cooperation opportunities solving the issue of modernisation and privatisation of Ukraine's natural gas transportation system. On September 13, 2010 in Brussels President of Ukraine Viktor Yanukovych met President of European Commission José Manuel Barroso. During their meeting Yanukovych and Barroso agreed to cooperate on issues pertaining to upgrading Ukraine’s natural gas system (the
initial stage being the preparation of two feasibility studies before the end of 2010).  

*The scenario of taking over Western rules of the game.* It is recommended that the modernisation of Ukraine’s natural gas transport system be implemented not so much by means of a tripartite / multilateral consortium model, as suggested by Ukraine, but rather by attracting Western companies and international financing bodies capable of fulfilling this modernisation. To make it possible Ukraine should finalize the process of its accession to the European Energy Community and reform its natural gas sector in accordance with the EU legal rules. The scenario of taking over the Western rules of the game essentially foresees that Ukraine will become a peculiar advocate for the EU in the energy relations between the EU and Russia. In other words, having adopted the EU acquis in the energy sphere, Ukraine could take over the role of Gazprom which sells natural gas to the EU and concurrently unilaterally forms terms of agreements for the transit of natural gas through Ukrainian territory. Should this scenario be fulfilled, the modernisation of Ukraine’s natural gas transportation system would be implemented in separate stages (modernizing separate sections of the gas transport system) while Ukraine would retain national control over its natural gas transportation system. These provisions were documented in the joint declaration between the EK and Ukraine’s government on March 23, 2009. According to the declaration, in 2010-2011 Ukraine would have to carry out reform of its natural gas sector using as the basis EU legal instruments, obligations which would be discussed during the negotiations on the Association agreement as well as Ukraine’s accession to the European Energy Community base. On the other hand, even if the West managed to upgrade Ukraine’s natural gas transport system, this scenario would hardly be implemented ignoring Russia. It could be emphasized that this scenario is based on economic benefit, which Russia could receive if Ukraine adopted European rules in the energy sector, while the West would upgrade Ukraine’s natural gas transport system for a price that would be several times less than that of Russia’s constructed pipelines. However, this scenario does not give consideration to Russia’s significance as a political player. Ukraine’s government understands this as well, which prompted it as early as in April 2010 to put forward an idea of a tripartite / multilateral consortium, in which Russia would take part, too.

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