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# Russian Gas, European Integration and the Fate of Ukraine

After years of protracted negotiations, Ukraine is almost ready to sign an Association Agreement with the European Union. Today, Robert Cutler describes how the agreement might impact the fate of Ukraine's Russia-to-Europe gas transit system.

By Robert M Cutler for ISN

Ukraine finds itself with a dilemma. If the EU—Ukraine Association Agreement (AA) is not signed and ratified soon, another chance is unlikely to arise for a generation or more. At the same time, separate negotiations have yet to determine whether Ukraine's gas transit system (GTS) will be administered by a bilateral consortium with Russia or a trilateral one with European Union (EU) participation. Accordingly, the final outcome of this decision - which is not Ukraine's alone and would involve upgrading and modernizing the GTS — also has the potential to influence Kiev's negotiations with the EU.

## Background to a stand-off

The EU has officially stated on numerous occasions the [three issues](#) that must be addressed for the negotiations to have a positive outcome. Of these, the highest-profile and best known is the release of imprisoned former prime minister and presidential candidate Yuliya Tymoshenko. However, Ukraine's ambassador to the EU has [rejected](#) any preconditions for the signature of the AA. As a result, everything still hangs in the balance and is the context for the more technical, but still political, negotiations over the sensitive future of Ukraine's GTS for natural gas from Russia to Europe.

Ukraine first moved towards unbundling its supply and transit contracts with Gazprom, as early as spring 2004 — before the Orange Revolution, when the current president Viktor Yanukovich was prime minister under then-president Leonid Kuchma. Although the objective behind the move was higher transit fees for Russian gas to Europe, the unexpected result was higher prices for gas from Russia.

In January 2005, the EU and Ukraine [signed](#) a Memorandum of Understanding on general energy cooperation. Later that year, the EU created the Energy Community Treaty, which provided for the EU *acquis* in the energy sector to be "exported" to the Western Balkan states through the adoption of EU legislation and norms.

## Ukraine and the EU's Energy Community Treaty

In practice, Ukraine moved decisively to cooperate with the EU over energy policy only following the

Russian gas cut-offs — lasting three days in January 2006 and 19 days in January 2009. The EU and Ukraine [opened](#) negotiations over energy issues in 2008, after the Energy Community Treaty had entered into force in mid-2006, with a view towards Ukrainian membership.

In September 2010, Ukraine and the EU [signed](#) the Energy Community Treaty accession protocol, which entered into force in February 2011. Ukraine's accession to the Energy Community Treaty requires it to implement the EU's Third Energy Package, including "unbundling". This means that Naftohaz Ukrainy, the Ukrainian party to the supply and pricing contracts with Gazprom, will cease to exist in its current form, requiring the renegotiation of gas import contracts with Russia within the new economic and legal environment.

The unbundling of Naftohaz Ukrainy changes the calculations of transit economics for Gazprom and Russia. For instance, Gazprom would have to compete with alternative sources being developed by Ukraine (such as domestic production both onshore and offshore, shale gas, and liquefied natural gas imports) that will enable the latter to change its pricing formula. As a result, Russia and Gazprom have been seeking to diminish or eliminate their dependence upon Ukraine as a transit country. This, in turn, has been one of the reasons behind political momentum in Russia for construction of the Nord Stream and South Stream gas pipelines.

The opening a few years ago of the Nord Stream gas pipeline under the Baltic Sea from Russia directly to Germany and Europe [threatens](#) Ukraine's place as a transit country. It makes the country's GTS potentially less valuable economically, even though its capacity utilization has fallen significantly (under its projected carriage of 55 billion cubic meters per year, bcm/y) since the pipeline's second "string" opened late last year. Gazprom now [repeats](#) the same warning to Ukraine in speaking about the long-planned but still troubled South Stream pipeline (which has an projected capacity of up to 63 bcm/y) designed to go under the Black Sea from Russia to the Balkans. Construction on the first string of South Stream, which would carry up to one-quarter that amount, began on the Russian end last December.

### **Questions about Ukraine's gas transit system**

Over the last two decades, the Russian state through its "national champion" Gazprom has become the proprietor of the GTS in several Soviet successor states by taking ownership in exchange for cancelling debts accrued as a result of gas imports. This possibility was discussed with Ukraine in the middle of the last decade, but in 2007, the Ukrainian Rada (parliament) passed a law written personally by then-prime minister Yuliya Tymoshenko. That law set out several different ways in which Ukraine's GTS could be alienated from state property and forbade them all in detail. The law has the force of a constitutional provision. There was talk of its repeal after Tymoshenko lost the 2010 presidential election, but this has not yet happened. An agreement signed with the EU in March 2009 in Brussels underlined that Ukraine's gas transit system is and will be the property of the Ukrainian state. A bill to permit its sale was nevertheless [introduced](#) in the Ukrainian parliament in the last days of April 2013, and the government has enough votes to pass it.

The Ukrainian GTS [includes](#) more than 60,000 kilometers of pipe plus 71 compressed air plants and 13 underground gas storage facilities. In its talks with Russia, Ukraine's four goals are to renegotiate current prices to a lower level, to reconsider the June 2009 gas bilateral delivery contract, to ensure the "stability and predictability" of gas supply especially via Ukraine to Europe, and to consider options for modernizing the gas transit network. From Moscow's standpoint, the problem is that even though the gas to Europe transits Ukraine, Russia as supplier is responsible for its delivery to the EU. Even in 2006 and 2009, EU customers raised no claims against Russia; nevertheless, Russia perceives a transit risk from Ukraine. The non-transparency of Ukraine's GTS and its inefficiency have made it difficult and sometimes impossible to trace the status of any discrepancy between the amount of gas

that Russia says it sends and the amount that Europe says it receives.

### **Possible solutions and future prospects**

Three years ago, the Russian ambassador to the EU, Vladimir Chizhov, said that his country welcomed proposals by Kiev for a "three-sided" plan to modernize Ukraine's gas pipeline network, with Moscow's involvement. At the time, Ukraine's Prime Minister Mykola Azarov [announced](#) that his government would look for a three-sided approach that would include Russia, a point that he [repeated](#) last September. However, the EU has been unwilling to discuss anything more about Ukraine's compliance with the administrative norms of the Energy Community, without any financial commitment on its own part. Earlier this year, an EU representative [remarked](#) that it was [interested](#) in a trilateral solution but that a bilateral Ukraine-Russia solution was also possible.

The IMF, the World Bank, and the EBRD are reported to have allocated US\$1.7 billion for industrial modernization projects, such as the replacement of old compressor stations responsible for important leakages. However, these loans have not yet been authorized. Talks with the IMF, which were expected to conclude earlier this month, ended inconclusively and are expected to resume in a few days from now.

Underneath all this geopolitical and geo-economic jockeying is the fate of Ukraine in the Euro-Caspian and Eurasian macro-regions. Russia wants Ukraine to join its Eurasian Customs Union (ECU) that already includes Belarus and Kazakhstan. Other Soviet successor states such as Kyrgyzstan and Turkmenistan are also [under pressure](#) to join. Yet Ukraine's legal obligations under the Energy Community Treaty, and especially the AA with the EU, are such that it would be impossible to join the ECU and to continue on a path of deepening European cooperation with the EU.

Despite early estimates that modernization of Ukraine's GTS could cost at least \$15 billion to \$20 billion, a group of German engineers who visited the country last year and looked at the question in specific detail arrived at the more modest [price-tag](#) of \$5.3 billion. A pilot demonstration project costing one percent of that amount is now under way in Ukraine with German industrial participation. Accordingly, Ukraine is again [caught](#) between the EU on the one hand and Russia on the other. The fate of its GTS is a bellwether, no less than the Tymoshenko case, for the political fate of Ukraine in the first half of the present century and beyond.

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For additional reading on this topic please see:

[The Level of Transparency of Oil and Gas Transit Operations through Bulgaria, Georgia, Turkey and Ukraine](#)

[At Any Price: Russia is Embarking on the Construction of South Stream](#)

[Lowering the Price of Russian Gas: A Challenge for European Energy Security](#)

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