

## Abstract

*The 2009 gas dispute between Ukraine and Russia has led to a severe drop in Russian gas supplies to some EU member states. The dispute has once again shown that the status quo is defective and unsustainable as a policy. This Policy Brief argues that – beyond ad hoc temporary measures, such as the monitoring by EU experts agreed on January 12<sup>th</sup> and the 2009-10 price agreement apparently reached on January 18<sup>th</sup> – the problem needs a comprehensive and robust solution. This would be a gas transit consortium, bringing all major stakeholders – Gazprom, Naftohaz, one or a few European energy companies, and the international financial institutions – to jointly manage the trans-Ukrainian trunk pipeline. The consortium agreement would be underwritten politically and legally by a tripartite treaty to be ratified by the EU, Russia and Ukraine. The consortium should be bound by European standards of transparency, corporate governance and accounting in order to tackle the major problem – the lack of trust – in the EU-Ukraine-Russia energy triangle.*

## 1. The New Year's debacle

As if the global financial and economic crises were not enough. The politicians and gas men of Russia and Ukraine have not only grossly mismanaged their bilateral gas transactions, but also, as collateral damage, cut gas supplies to many EU countries in the midst of the winter's severest freeze. South-East Europe has been hardest hit, Bulgaria most of all, with reduced city heating. Industrial users of gas have closed down in Bulgaria, Slovakia, Bosnia and Croatia.<sup>1</sup> Supplies into Austria stopped completely,

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<sup>1</sup> "Christmas lights go out as chill spreads across south-east Europe", *Financial Times*, 8 January 2009.

## The Case for a Gas Transit Consortium in Ukraine: A Cost-Benefit Analysis

**Elena Gnedina & Michael Emerson**

and the country is now surviving on reserves. If the stoppage were to continue and reserves run down, there would be major disruption of both domestic heating and industrial production at the heart of the European Union.

Russia and Ukraine are swapping accusations of blame. Neither side seems to be fully sincere or reasonable. Russia accuses Ukraine of not paying its debts and stealing gas intended for Europe, and therefore stopped all supplies to Ukraine on 1 January 2009. Ukraine denies the theft and accuses Gazprom of trying to exact excessive prices and/or of refusing a parallel rise in transit fees. Russia insists that Ukraine repay its gas debt of \$2.4 billion (of which all but \$614 million was paid as of 1 January 2009), while at the same time tolerating Transnistria's comparably large debt.<sup>2</sup> As regards the gas price, Gazprom made references to European gas import prices, saying that under the system of indexation on oil prices (time lagged by 6 to 9 months), Germany could currently be paying around \$500 per thousand cubic metres (tcm). But with the recent collapse of the oil price, the gas price is expected to fall to around \$250-300/tcm for Germany in 2009, from which for Ukraine there is a 'netback' factor to be deducted for its lesser transport costs. But in any case the precise indexation formula

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<sup>2</sup> Transnistria is a secessionist state and formally part of the Republic of Moldova. Its gas debt to Gazprom, according to different estimates, ranges from \$1.5 billion to \$1.8 billion.

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for imports into the EU is kept secret. There is surely now a public policy case for these price contracts to be made public. Similarly, Ukraine contests the current price of \$1.7/tcm per 100km for the transit of Russian gas, with President Yushchenko wishing to raise the price substantially.<sup>3</sup>

Ukraine's gas transit system (GTS) – yearly transporting around 120 billion cubic metres or 80% of Russia's gas to Europe – is at the centre of the problem. It is managed by Ukrtransgas, a subsidiary of a state energy company, Naftohaz. Due to defective economic governance, Naftohaz is constantly close to bankruptcy and indebted to Gazprom, while the GTS is in a deplorable state of technical depreciation. These problems are exacerbated by Ukraine's highly volatile relations with Russia, which has not been ready to subsidise its gas supplies to Ukraine without political and economic concessions on Ukraine's part.

Surprisingly, despite recurrent crises, reputational damage and the evident dysfunctionality of the Ukraine-Russia energy relationship, there has been little attempt on either side to reach a pragmatic solution that would once and for all free the gas trade of political tensions and mischievous trade practices. Given this situation, it is the right time for the EU – badly affected by this crisis – to make the case for its intervention.

The EU agreed with Russia and Ukraine on January 12<sup>th</sup> on the deployment of monitors, whose role it is to provide oversight on the ground and reassurance against gas theft (see Appendix 1). But this did not lead to the expected resumption of supplies immediately. As the supply blockage remained in the week that followed, various technical solutions were discussed, including recourse to gas swaps (between Russia, Ukraine and Bulgaria) and a temporary 'consortium'<sup>4</sup> of European gas producers who would fund the re-filling of the Ukrainian gas pipeline (see Appendix 2). Only on January 18<sup>th</sup>, after a high-level meeting in the Kremlin between Russia, Ukraine, the EU and some other South-East European countries, was a price agreement reached between Putin and Timoshenko for 2009 and 2010. The 2009 price is to be the prevailing European price less a 20% discount with no change to the transit fee, and the 2010 price at the full European price (available details are given in Appendix 3, but so far these references to the 'European price' give no indication of what the

Ukrainian 'netback' factor might be). The price agreement is due to lead to the signature of supporting documents on January 19<sup>th</sup> and thence the resumption of supplies to Europe shortly afterwards.

These mechanisms and agreements, however, can be regarded as ad hoc temporary measures that are not going to address the major problem, which is that of the alleged gross corruption and in any case the lack of transparency and goodwill in the gas trade between the Ukraine and Russia. All major stakeholders have no other option but to look for a genuine and comprehensive solution until alternative options become available.

## 2. Alternatives

In recent years the Nord Stream pipeline project that would run through the Baltic Sea from Russia to Germany has been presented by Russia as the best alternative to Ukraine's GTS. This opinion has not been fully shared in the EU. On 13 November 2008, Putin – visibly irritated – made his 'take it or leave it' offer to the EU. "Europe has to decide: if they need [Nord Stream] or not. If not, we will renounce the project, build LNG facilities and sell gas to other markets", he stated at a press conference with the Finnish Prime Minister.<sup>5</sup> Reportedly, this was the first time Putin admitted that negotiations on the Nord Stream pipeline were running into serious difficulties.

There might be several reasons for this revelation. Russia might not be able to ensure the money or resources to implement this project. The politicking – that of avoiding 'insecure' transit countries – could have to give way to simple economic arithmetic. The transit pipeline on the Baltic Sea bed, with a capacity of 55 billion cubic meters of gas per year, would cost \$11.5 billion to build (some estimates are even higher). This will be hard to obtain. The gas price will fall drastically in 2009, following the price of oil, and leave Gazprom cash-strapped and further indebted. The exploration of the Shtockman gas field – where the gas is supposed to come from starting in 2013 – is expected to be riddled with financial difficulties and harsh weather conditions.<sup>6</sup> The Nord Stream could be developed only with huge borrowings from western banks, while for the Shtockman field the exploration company will need both tax breaks and the expertise of foreign

<sup>3</sup> "President otkopal trubu voiny" ("President has dug out the pipe" – our translation), *Kommersant-Ukraina*, 14 January 2009.

<sup>4</sup> This temporary financing 'consortium' should not be confused with the long-term pipeline concession consortium that is principally advocated in this paper.

<sup>5</sup> "Vladimir Putin ne prozeval tretii srok" ("President Putin has not missed the third term"), *Kommersant*, 13 November 2008 (<http://www.kommersant.ru/doc.aspx?DocsID=1056718>).

<sup>6</sup> "Shtokman bez nalogov" ("Shtokman without taxes"), *Vedomosti*, 10 December 2008 (<http://www.vedomosti.ru/newspaper/article.shtml?2008/12/10/173051>).

companies. The current financial crisis and Russia's protectionist policies in the energy sector make both of these conditions uncertain.

Political controversies around the Nord Stream only increase its cost. Putin's irritation might have been caused by the scepticism of some EU member states with regard to the project. While Gazprom hired former Chancellor Gerhard Schroeder as a chairman of the Nord Stream board and secured the support of Germany, and former Finnish Prime Minister Paavo Lipponen as a consultant the project has had a rough ride in the Baltic states and Sweden, through whose economic zones it will have to run. Gazprom has to consider their environmental concerns. It has also had to withstand certain Polish commentators comparing it to the Molotov-Ribbentrop Pact, and to address fears about Gazprom using the pipeline for espionage purposes. Instead of alleviating these fears, Putin – seemingly carried away by his 'great power' rhetoric – let slip another 'warning' to Europe.

The EU – slowly trying to diversify its energy sources away from excessive dependence on Russia – did not fare better. Its current energy policy highlights its past short-sightedness. It started to seriously consider diversifying its gas suppliers away from Russia only after the Russian-Ukrainian gas dispute in 2006. In 2003 Russia was already negotiating profitable contracts in Central Asia, which did not contain tiresome human rights clauses. When the EU started venturing into Central Asia in 2006,<sup>7</sup> it found itself unable to secure enough gas for its diversification projects, such as Nabucco or a Trans-Caspian pipeline. This has put Nabucco at a disadvantage compared to the South Stream project that would cross the Black Sea, and which was more aggressively pursued by Russia. When questioned about Nabucco, Putin said that he could not care less about the EU "digging up soil and burying its pipelines".<sup>8</sup> However, the Nabucco project, several times declared dead, seems now to attract more interest than ever.

As Russia and the EU look towards diversification projects, in the midst of a severe gas crisis there needs to be an urgent solution to the Russia-Ukraine imbroglio before trust among these main players thins out completely. Developing cooperation on the Ukraine's GTS is essential. It would also be the most

economically feasible way to increase energy security in Europe and to reverse the atmosphere of mutual distrust that pervades the EU-Ukraine-Russia triangle.

### 3. The problems of the status quo

Even during the Cold War – despite ideological differences – the USSR delivered gas to Austria and Germany through the Ukrainian pipeline system. However, in the winter of 2006 Russia cut off the gas supplies to Ukraine due to their disagreement over gas prices. This dispute for the first time had a European dimension, as Ukraine withdrew some gas from the transit pipeline, destined to Gazprom's European customers, without Gazprom compensating the missing amount.

The 2006 gas dispute increased the mistrust of many EU member states towards Russia and made the EU rethink its reliance on Russian gas. Since then Gazprom has been sending its officials over to Brussels in the hope of repairing its damaged reputation in the EU and national capitals. Meanwhile Ukraine – perceived as a victim of economic aggression – won support from the EU in the form of 'enhanced' cooperation and financial assistance. In 2006 Ukraine signed a Memorandum of Understanding on energy with the EU, highlighting the convergence of EU and Ukrainian energy interests. In 2007 and 2008 Ukraine received a total of €157 million from the EU for its energy reform.<sup>9</sup> In November 2008 it started negotiations on joining the Energy Community Treaty. In March 2009, the EU plans an investment conference, to be chaired by the Czech Presidency, to raise funds for the rehabilitation of Ukraine's pipelines.

The current crisis shows that the status quo is not sustainable, as Ukraine and Russia only swept the existing problems under the carpet without solving them. Several lessons stand out for the EU here. First, Ukrainian elites cannot be simply acquitted of their own wrongdoings such as rent-seeking and corruption. Cooperation between the EU and Ukraine cannot advance without Ukraine reforming its energy sector. Second, the EU cannot have any meaningful cooperation on gas with Ukraine, without Russia being part of a transparent dispute-settlement mechanism and a wider cooperation framework. The energy early-warning mechanism, launched during the 2007 EU-Russia summit in Portugal, and an invitation to the EU monitors to deploy the Ukrainian-Russian border during the

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<sup>7</sup> V. Socor, "Central Asia-Europe energy projects: Itemizing what went wrong", *Eurasia Daily Monitor*, 4 (106) 2007 (available at [http://www.jamestown.org/single/?no\\_cache=1&tx\\_ttnews\[tt\\_news\]=32777](http://www.jamestown.org/single/?no_cache=1&tx_ttnews[tt_news]=32777)).

<sup>8</sup> "Russia, Hungary sign South Stream pipeline deal", *International Herald Tribune*, 28 February 2008 (<http://www.ihf.com/articles/ap/2008/02/28/europe/EU-GEN-Russia-Hungary-Pipeline.php>).

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<sup>9</sup> 2008 Joint EU-Ukraine report on energy cooperation (available at [http://ec.europa.eu/energy/international/bilateral\\_cooperation/doc/ukraine/2008\\_08\\_29\\_progress\\_report.pdf](http://ec.europa.eu/energy/international/bilateral_cooperation/doc/ukraine/2008_08_29_progress_report.pdf)).

ongoing crisis are just the first steps. Finally, the EU has been keen on establishing a rule-based order and a sort of energy security architecture for all parties, as reflected in the Energy Charter Treaty (ECT). But this is only possible when all parties are able to agree on the *rationale* of the EU-proposed order, which is not the case now: hence Russia's failure to ratify the ECT. The EU has had to concentrate on small-scale and issue-based cooperation projects, which might perhaps lead to a more comprehensive partnership.

The current problematic state of the EU-Ukraine-Russia energy relations is characterised by a lack of trust, a state of insecurity caused by a high degree of interdependence and an excessive politicisation of the energy trade. The 2006 and 2009 Ukraine-Russia gas disputes highlight how commercial disputes can spin out of control into major political crises. The crises have led to a proliferation of diversification projects, some of which at least have a shaky economic rationale. They turn an economic policy issue into a subject of fierce political competition and a battle for power. As a result, in recent years the EU, Ukraine and Russia have become even less trusting of each other as partners.

Moreover, a number of more precise problems need urgent solution.

*Lack of rehabilitation of GTS and corruption in Ukraine.* Due to mismanagement and a lack of investment, the GTS is in a poor condition. Built in the period from 1950 to 1970, already in 2004 22% of the Ukrainian pipelines exceeded their originally planned life span of 33 years, and 66% were between 10 and 33 years old.<sup>10</sup> This increases the risk of technical break-downs and jeopardises the Russian gas (80%) that is exported to the EU. In 2007 a Commission study estimated that around €2.5 billion would be needed to rehabilitate Ukraine's GTS.<sup>11</sup> The lack of capital investments is due to the financial difficulties of *Naftohaz Ukrainy*, which has been and remains heavily indebted to Gazprom and risks bankruptcy. Citing the strategic importance of Naftohaz, the government of Ukraine has time and again bailed out the defaulting company.<sup>12</sup>

Naftohaz is also the expression of a much bigger problem: the Ukrainian energy sector is run by non-transparent gas traders under the connivance of

corrupt elites. As a result of the 2006 crisis a non-transparent gas agreement was concluded between Russia and Ukraine. It was agreed that a mix of cheaper Turkmen and more expensive Russian gas would be delivered to Ukraine by an intermediary company, RosUkrEnergo, owned 50% by Gazprom and 50% by Ukrainian businessmen (notably Mr Dmitri Firtash who alone holds a 45% share), and which has been able to receive a huge rent from its intermediary role.<sup>13</sup> RosUkrEnergo also traded gas profitably with chemical, steel and machine-building industries in Ukraine, and according to Firtash, now controls of 75% of Ukraine's domestic gas market.<sup>14</sup> In the meantime Naftohaz supplies gas to cash-strapped private households and municipal authorities, most often at a loss. As a result, by December 2008, *oblhazy* (regional distributors of gas) had accumulated huge debts to Naftohaz, while in its turn Naftohaz had accumulated a debt of \$2.4 billion to Gazprom. The non-payment of the gas debt by Naftohaz and the lack of a gas supply agreement between Ukraine and Russia for 2009 resulted in Gazprom cutting off its gas supplies entirely into Ukraine on 1 January 2009, including supplies that should have gone to Europe.

*Lack of security of supplies.* Due to the precarious state of Ukraine's energy sector and the high volatility of Russian-Ukrainian relations, both the EU and Russia have concerns over the security of transit of gas through Ukrainian territory. The 2006 and 2009 gas disputes are alarming for those EU member states that are most highly dependent on Russian gas (e.g. Germany, Hungary, Poland, Bulgaria and Slovakia). See the map on the following page. The conflicts demonstrate that not only technical faults but also political tensions can adversely affect EU energy security. Importantly, the lack of transparency, an adequate alert mechanism and proper infrastructure (such as meter stations) means that the EU has not been able to closely monitor Ukrainian-Russian energy trade. As a result of the new cut in supplies in January 2009, it has been agreed that a team of EU, Russian and Ukrainian monitors would be deployed to check the supply system at the Russian and Ukrainian frontiers. But, as already mentioned, this positive move has not yet seen resumption of supplies, and in any case is no more than a stop-gap measure.

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<sup>10</sup> S. Pirani, *Ukraine's Gas Sector* (2007), Oxford Institute for Energy Studies, p. 81.

<sup>11</sup> 2007 Joint EU-Ukraine report on energy cooperation, p. 3 (available at [http://ec.europa.eu/energy/international/bilateral\\_cooperation/doc/ukraine/2007\\_09\\_14\\_progress\\_report.pdf](http://ec.europa.eu/energy/international/bilateral_cooperation/doc/ukraine/2007_09_14_progress_report.pdf)).

<sup>12</sup> In 2008 Naftohaz was bailed out twice. In early October, the government's bailout was of a total value of \$1.7 billion.

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<sup>13</sup> According to its audit reports, RosUkrEnergo earned \$795 million in 2007 and \$785 million in 2006. See <http://www.rosukrenergo.ch>.

<sup>14</sup> "RUE kontroliruet 75% prodazh gaza na Ukraine" ("RUE controls 75% of gas trade in Ukraine"), *Vedomosti*, 11 January 2009.



Source: BBC (<http://news.bbc.co.uk/2/hi/europe/7830517.stm>).

*Non-ratification of the Energy Charter Treaty (ECT) by Russia.* Russia has refused to ratify the Energy Charter Treaty, signed in 1994. In addition the complementary draft Transit Protocol could not be agreed. The ECT and the Transit Protocol would have established legally binding rules for international energy trade and transport, based on liberalisation, non-discrimination and competition. The lack of ratification by Russia showed that it wanted to retain its monopolistic position as a principal supplier and transit country of gas to Europe. Norway's refusal to ratify the ECT only strengthened Russia's position.

Although the Russian leadership questions the value of the ECT and the Transit Protocol, the treaty could be most favourable for Russia's energy transit through Ukraine. The ECT and Transit Protocol prohibit the diversion of gas from the transit infrastructure and provide a dispute settlement mechanism.<sup>15</sup> If it were ratified, Russia could resort to an external and impartial arbitration mechanism and seek compensation for damages, if Ukraine syphons off gas from the transit pipe or does not pay for gas deliveries.

<sup>15</sup> See [www.encharter.org](http://www.encharter.org).

*Financial crisis.* The global financial crisis that unfolded in 2008 has hit Russia with a new dimension to the existing problems. For a few years now energy experts have been expressing doubts over Russia's capacity to fulfil its gas exports commitments.<sup>16</sup> Due to mismanagement, low gas prices in Russia and expansionist investments in new pipelines, downstream assets in Europe and non-core businesses, Gazprom has been investing little in the exploration of new gas fields.<sup>17</sup> As a result it is expected to run into a possible gas deficit of 126 bcm of gas by 2010.<sup>18</sup> Its main strategy was to compensate for its own gas shortage by becoming the monopolistic buyer of Central Asian gas. The latter is essential for Russia to deliver on its

<sup>16</sup> A. Riley, *The Coming of the Russian Gas Deficit: Consequences and Solutions*, CEPS Policy Brief No. 116, 2006; International Energy Agency, *Optimising Russian Natural Gas: Reform and Climate Policy*, 2006; V. Milov, Coburn and Danchenko, "Russian Energy Policy 1992-2005", *Eurasian Geography and Economics* 304, 2006, pp. 285-313.

<sup>17</sup> V. Milov and B. Nemtsov, *Putin I Gazprom* (in English 'Putin and Gazprom'), Moscow, 2008 (online version in Russian: [http://www.milov.info/cp/wp-content/uploads/2008/10/broshura\\_gazprom\\_1.pdfV](http://www.milov.info/cp/wp-content/uploads/2008/10/broshura_gazprom_1.pdfV)).

<sup>18</sup> Riley, op. cit., p. 1.

commitments until new gas fields are operating (e.g. Yamal, Shtockman, Sakhalin-2 and Yuzhno-Russkoe). It is also part of a strategic design, whereby Russia wants to remain the only transit bridge between gas-rich Central Asia and Europe. As the financial crisis has hit Europe and Russia, Gazprom has even less access to funding for new gas fields. It is forecast to lower the price of gas for European customers from \$460-500 to \$280 in 2009 due to its indexation on the fall of oil prices from \$140 to \$40/barrel in the second half of 2008. As a result, its export revenues are expected to fall by 31.7% or \$20 billion in 2009.<sup>19</sup> Thus, Gazprom might be less able or inclined to spend large sums of money on expensive diversification projects. Hence, Putin's vacillation on the prospects of the Nord Stream.

#### 4. A Gas Transit Consortium in Ukraine

An international gas transit consortium – bringing Ukraine, the EU and Russia to jointly manage the Ukrainian trunk gas pipeline – could in this situation provide a solution, addressing the energy security challenges of Russia as a supplier, Ukraine for its transit role, and the EU as consumer. It could be a win-win-win solution. The joint EU-Russia-Ukraine management of the Ukrainian GTS could become a stepping stone towards a more comprehensive arrangement on energy security in Europe, as was the case of France and Germany within the European Coal and Steel Community.

An attempt to establish such a consortium was undertaken in 2002.<sup>20</sup> Then, after some unsuccessful attempts by Russia to acquire Ukraine's pipelines in exchange for the settlement of Ukraine's debts, Gazprom pressured President Kuchma to agree on an international consortium to manage the Ukrainian pipelines. Ruhrgas (now E.ON/Ruhrgas), a German energy giant and a close partner of Gazprom, joined the negotiations later. However, the parties never achieved a compromise on the structure of the consortium. Ukraine was afraid of Gazprom taking full control of the GTS, not least with the help of Ruhrgas. The EU, which could have provided an

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<sup>19</sup> "Gazprom poteriaet v Evrope \$20 milliardov" ("Gazprom will lose \$20 bln in Europe"), *Kommersant*, 15 December 2008 (available at <http://www.kommersant.ru/doc.aspx?DocsID=1094437>).

<sup>20</sup> A possibility to establish an international gas transportation consortium has been evaluated by Razumkov Centre, *Gas Transportation Consortium*, National Security and Defense Magazine No. 1, 2004 (available at [http://www.uceps.org/files/category\\_journal/NSD49\\_eng.pdf](http://www.uceps.org/files/category_journal/NSD49_eng.pdf)); and World Bank, *Ukraine: Challenges facing the gas sector*, 2003.

external guarantee against such a takeover, did not play any role.<sup>21</sup> In 2004 the parties returned to the status quo. Now – as bilateral energy cooperation in the EU-Ukraine-Russia triangle has proved so defective – the parties need to return to the discussion of a robustly structured multilateral solution.

*What might be the structure of a fresh attempt?*

Three types of arrangement between the consortium and the Ukrainian state could be considered:

- First, the Ukrainian government could sell a stake in Ukraine's GTS to a consortium. This would allow Ukraine to raise a large sum of money upfront but it would have to relinquish control over the pipelines indefinitely.
- Second, the pipeline could be subject to a concession granted to a consortium for a long period. The consortium operator would lease the pipeline for a fee and assume the obligation to manage, maintain and enhance the system. Ukraine would remain the owner of the pipeline upon the termination of the concession period.
- Third, under a management contract, Ukraine could transfer the management of the GTS to a consortium for a fee, but remain under obligation to rehabilitate the system itself.

As Ukraine understandably considers the GTS as a strategic asset, it will resist the first option. Currently, the privatisation of the GTS is prohibited by a law "On Pipelines" that was almost unanimously voted in by the Ukrainian parliament in February 2007. On the other hand, a management contract would leave the need to finance major investments in the rehabilitation of the GTS with the Ukrainian government, which would mean enduring risks and uncertainties. As the middle way, a concession of the major pipeline trunk for a period of between 25 to 50 years would seem the most acceptable solution for all parties.

Due to the high sensitivity of the subject, consortium negotiations would need to be conducted at both corporate and political levels.

The European Commission might begin the process with a feasibility study and propose the first draft of the consortium agreement. The corporate negotiations should be conducted by Gazprom, Naftohaz, one or more European energy companies and the EBRD. The European participation might be selected on the basis of an open competition (in the past Ruhrgas, Gaz de France, ENI and Shell

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<sup>21</sup> For a detailed investigation of the consortium negotiations, see Elena Gnedina, "Ukraine's Pipeline Politics", forthcoming.

demonstrated an interest in participating). The consortium would take the form of a public-private partnership, and could also secure substantial funding from the participating governments, the European Commission, the EBRD, EIB and the World Bank. The EBRD in particular is able to take equity share participation in such projects. The EIB and World Bank could supply substantial loan capital. The division of shareholdings between participants could take many different formulas in the detail. However from a strategic point of view it would seem plausible that neither the EU, Russian nor Ukrainian party would have a dominant position, for example 30% each with a remaining 10% taken up by the EBRD. The role of the EBRD could be particularly valuable, since its professional task would be to assure the correct corporate governance of the consortium; while politically it is important that the EBRD is itself owned and controlled not just by EU and Western interests, but also by the governments of Eastern Europe including Russia and Ukraine.

The EU, Russia and Ukraine would provide the political guarantees. As well as an agreement between consortium participants there should be a binding treaty establishing the ground rules, signed and ratified by the EU, and Russian and Ukrainian governments. The treaty would inter alia protect the consortium from political instability and establish the highest level legal basis for its operations. In particular it should specify how the trunk pipeline of the consortium would be legally and managerially separate from the domestic Ukrainian gas distribution network. It should further guarantee the ground rules for the setting of transit fees, which would be the secure revenue base of the consortium, and hence a bankable basis upon which to raise funding for renewal and repair of the pipeline. The parties should not be able to sell their stakes to other parties of the consortium. The Ukrainian government has to remain the ultimate owner of the pipelines, while it has to share the benefits from using the GTS with other parties.

There are indications that Moscow remains interested in the consortium idea. On 5 June 2008 in a speech in Germany, Medvedev said that Russia was “ready to consider a possibility to establish international consortiums, which would operate transit pipelines together with the companies from Russia, the EU and transit states”.<sup>22</sup> Putin has echoed these ideas more recently. Both Putin and Medvedev themselves point out that Russia is ready to organise relations with the EU and Ukraine on a pragmatic

<sup>22</sup> Medvedev’s speech, Germany, 5 June 2008 (available at [http://www.kremlin.ru/appears/2008/06/05/1923\\_type63374type63376type63377\\_202133.shtml](http://www.kremlin.ru/appears/2008/06/05/1923_type63374type63376type63377_202133.shtml)).

and commercial basis. There are in fact many examples already of Gazprom participating in gas distribution networks in Europe, with different shareholdings and public-private partnership arrangements (see the box below and Appendix 4).

#### *Gazprom’s investments in the CIS and the EU*

Gazprom already owns substantial stakes in European energy companies, including those having monopolistic rights in gas trade or transmission (see Appendix 4). For instance, Gazprom participates as shareholder in energy companies in Lithuania, Poland, Latvia and Hungary, together with their governments and European partners. In Slovakia it is part of the trilateral consortium with Ruhrgas and Gaz de France, which bought 49% of the transit pipeline from the Slovak government. In most cases Gazprom’s participation did not lead to energy blackmail or a hostile takeover of these companies and energy infrastructure by Gazprom.

Instead, there is a clear trend on the part of major stakeholders not to politicise ongoing disputes and to resolve them as commercial matters. For instance, 48% of shares of Europol Gaz in Poland – the consortium that owns the Polish part of the Yamal-Europe pipeline – belong to Gazprom. The other 48% of its shares are owned by the state company PGNiG. In January 2007 Gazprom asked PGNiG to lower the transit fees for Russian gas. It also demanded an increase in its decision-making rights beyond the original 1993 agreement. According to a report in the *International Herald Tribune*, 16 January 2007, PGNiG refused. Despite poor Polish-Russian relations, the dispute was kept low-profile, referred to a court and solved as a commercial dispute. This contrasts with the inflammatory rhetoric used by Poland and Russia towards each other in other cases, such as over Russia’s ban on Polish meat and the Polish veto preventing negotiation of a new EU agreement with Russia in 2005.

Ukrainian politicians also returned to the discussion on the consortium. In October 2006 President Yushchenko – after a telephone conversation with German Chancellor Angela Merkel – announced his support of the trilateral consortium, including Germany and Russia.<sup>23</sup> In February 2007 Yanukovich, then Prime Minister, pleaded in favour of a 50/50 Gazprom-Naftohaz ownership of the Ukrainian GTS but this met resistance from the President and the Verkhovna Rada (Ukraine’s

<sup>23</sup> V. Socor, “Russian-Ukrainian ‘international’ gas transportation consortium back on the agenda”, *Eurasia Daily Monitor*, 3(190) 2006 (available at [http://www.jamestown.org/single/?no\\_cache=1&tx\\_tnews\[tt\\_news\]=32132](http://www.jamestown.org/single/?no_cache=1&tx_tnews[tt_news]=32132)).

Parliament).<sup>24</sup> Yulia Tymoshenko, current Prime Minister, has not yet taken a position in this debate. She might welcome the three-party consortium idea, as it is generally in line with the policy of balancing between the EU and Russia, to which she increasingly adheres. Thus, the idea might become a successful testing ground for Ukraine's national unity.

Finally, the EU might, as already mentioned, find it quite possible to reach a consensus on the consortium idea. The current Czech Presidency has put energy as a priority field of cooperation with the EU's eastern neighbours. The earlier draft of the Eastern Partnership stated that public/private approach "bringing together third country producers and transit countries with the EU (...) is necessary for key infrastructures that face heightened non-commercial risks". Although removed from the final draft, the argument – reminiscent of the consortium idea – might still resurface in the coming months. For the current Czech Presidency and the next Swedish one, the consortium project could become a major economic and political achievement, and serve as a stepping stone towards a more comprehensive energy agreement with Russia.

## 5. Benefits and costs

For its success, every party needs to have a clear understanding of its potential benefits and costs.

### Ukraine

*Benefits.* First, Ukraine will be able to raise funds to rehabilitate its pipelines. Second, it will have a guarantee that sufficient volumes will transit through its territory. By offering stakes to Russian and European companies, Ukraine will solve its current dilemma. If it relies on close and non-transparent relations with Russia, it runs the risk of slowing down cooperation with the EU. If it has tense relations with Russia, it might potentially lose a prominent place as a transit country for Russian gas. The consortium will bring all three parties to finance, decide and supervise the transit of gas through Ukrainian territory.

*Costs.* In order to establish the consortium Ukraine will have to reform its energy sector and assure its transparency. Moreover, it will need to cede concession and management rights to a consortium with the EU and Russia. In both respects the Ukrainian leadership could meet internal opposition.

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<sup>24</sup> Mostovaya, "Eshche raz o deshevom syre" (adaptation of a Russian popular saying: "Once again about cheap cheese"), *Zerklo Nedeli*, 10 February 2007 (available at <http://www.zn.kiev.ua/1000/1030/55839/>).

In order to achieve consensus on the domestic scene, the Ukrainian leadership should make it clear that the consortium will not be established if one party – the EU or Russia – is missing. There should also be a built-in guarantee that Ukraine's GTS will not end up in the hands of Gazprom alone, for example as a result of a swap of assets between Gazprom and some of its close partners in Europe. As mentioned above, Gazprom has already demonstrated its support for a consortium project, which should serve to convince those in Ukraine who prefer closer cooperation with Russia.

The Ukrainian leadership could also rely on the support of the EU in promoting reform of the energy sector. Both the Association Agreement and Deep Free Trade Area – which are currently being negotiated – should include provisions on the reform of the energy sector. The EU's Energy Community Treaty – which so far brings together the EU and its Balkan neighbours, but which Ukraine aspires to join as a member – requires that the EU energy *acquis* is fully transferred into the domestic legislation of the candidate country. The EU should assist in this process by giving regulatory, financial and technical assistance. Russia's cooperation in eliminating non-transparent schemes in Ukrainian-Russian gas trade would also be welcome.

### Russia

*Benefits.* The consortium will address a major problem that Russia faces in its relations with Ukraine. It will offer Russia a stake in Ukraine's GTS and better oversight over the flow of gas to Europe. It will protect Russian gas from 'unsanctioned' withdrawal (or alleged 'theft') and give Russia a mechanism with which to redress the problems if Ukraine breaks its commitments. The EU's participation will avert the need for Gazprom to alert or request the help of the EU when it faces problems with Ukraine (as is currently the case).<sup>25</sup> Second, Russia could afford to hold back its very costly diversification projects, such as Nord Stream and South Stream until better times, and in the meantime work could go ahead without delay on the maintenance and expansion of the existing capacities in Ukraine. Finally, Russia will start an energy cooperation project both with the EU and Ukraine that might take a lot of conflict potential out of their relations.

*Costs.* First, Gazprom would not exercise control over the entire GTS and would have to share it with an EU counterpart. This could be perceived as a failure by Gazprom, which managed to acquire

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<sup>25</sup> "Gazprom issues warning on Ukraine pipes", *Financial Times*, 10 December 2008.



substantial stakes in energy companies all over Europe (including in some Russia-sceptical states and CIS states).<sup>26</sup> But even in the years of maximum rapprochement between Ukraine and Russia during Kuchma's second presidential term, Gazprom did not manage to come any closer to its objective. Instead, it had to limit its presence in Ukraine's market to some palliatives, such as intermediary gas traders (Rosukrenrgo or EuralTransGas earlier), half of which belonged to Gazprom with the other half belonging to Ukrainian shareholders.

Second, the EU might want as a condition to see the ECT and its draft Transit Protocol agreed and ratified by Russia. In line with its past behaviour Russia would be strongly opposed to this. The possible solution might be a half-way agreement. The consortium would be bound by the rules of the ECT and its transit provisions, as they have been ratified by Ukraine. Their provisions would be applicable only to the consortium and Ukraine's GTS, while they would remain void on Russian territory due to Russia's non-ratification. This could be presented as a viable argument for those in Russia, who would see the ratification of the ECT as a concession to Europe and oppose it.

### **The European Union**

*Benefits.* First, it would assure the non-problematic transit of current or increasing volumes of gas to Europe. Moreover, the EU could further bind Ukraine and Russia to European standards of transparency as regards the management of gas transit through Ukraine. The consortium would also amount to a middle-ground position, which could find consensus between those EU member states that give priority to cooperation with Russia (like Germany, Italy, Bulgaria and Greece) and those that are looking for more engagement with Ukraine (Poland, the Baltic states, Sweden and the UK). Thus, the consortium would have a better chance of winning consensus within the EU than current projects such as Nabucco, Nord Stream or South Stream.

*Costs.* With regard to the ECT and Transit Protocol, the EU would have to accept the limit of their application to the consortium in Ukraine, leaving further negotiations with Russia on these agreements to a later stage. Given that it is unrealistic to expect that Russia will ratify the ECT in the foreseeable future, any half-step in that direction is better for the EU than the status quo.

The EU will continue to rely heavily on gas deliveries from Russia through Ukraine. This could

possibly meet with opposition from those who look for diversification away from these countries. Although this point of view has a political and economic rationale, the EU cannot in the short or medium term avoid its great reliance on both Ukraine and Russia. Proposed diversification projects could only cover part of Europe's needs for gas and would not be able to substitute for Russia and Ukraine as the EU's main energy partners. Hence, the establishment of the consortium would only provide a guarantee that Russian gas – in sufficient volumes – would be safely delivered to the borders of the EU.

## **6. Conclusions**

The January 2009 interruptions of gas supplies from Russia to the EU via Ukraine, following the earlier 2006 crisis, has confirmed the absolutely intolerable situation in which a commodity of strategic importance for European industry and households has become uncertain and erratic, in breach of long-term supply contracts, as a result of disorderly commercial and political relations between Russia and Ukraine.

The recently agreed tri-partite (EU, Russia, Ukraine) monitoring system is a positive step, even if at the time of writing (19 January) supplies have not yet resumed. But in any case this can be viewed as no more than a stop-gap measure. A more fundamental and permanent solution is required. For this purpose we propose that the EU, Russia and Ukraine negotiate the creation of a new business consortium to be granted a long-term concession to operate the Ukraine trunk gas transit pipeline. The consortium agreement should be supported by a treaty to be signed and ratified by the EU, and Russian and Ukrainian governments, thus providing legal, economic and political guarantees for the new venture at the highest level.

The consortium proposition does not offer an overarching solution to the problem of security of energy supplies for the EU. However it could serve the needs of all the parties involved, mending the existing cracks in EU-Ukraine-Russia cooperation. Whether they like it or not, all three parties are highly dependent on each other. Thus, they need to exploit every opportunity to re-launch their energy cooperation.

Nor would the project be a substitute for diversification projects in the EU and Russia. Strategic thinking dictates that a country should not allow itself to rely on one supplier or consumer, especially for strategic energy supplies. The rationale for diversification is admitted by all parties. But a successful EU-Ukraine-Russia consortium would permit a de-escalation of tensions in their relations

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<sup>26</sup> See Appendix 4 for a listing of Gazprom's participation in other energy companies throughout Europe.

and allow each others' diversification plans to be viewed with less reserve and more understanding.

More transparency and cooperation – not disengagement – should be the answer to the existing EU-Ukraine-Russia energy challenges. The gas transit consortium – aimed at decreasing mutual insecurities – might improve not only the energy situation but also serve as a model of international corporate governance, and even help improve the geopolitical climate in Europe. At a time when bilateral relations between both the EU and Russia and between Russia and Ukraine are badly in need of substantial improvement, and when the parties'

numerous political declarations ring so hollow, a concrete project with these qualities might be worth even more than a huge quantity of safely delivered gas. The EU should push for such a solution, indicating moreover that it would be treated as a necessary complement to the proposed new Association Agreement between the EU and Ukraine, and to the proposed new Agreement between the EU and Russia. An outright condition of concluding these new agreements would be the resolution of this appallingly disorderly gas transit affair.

## Appendix 1.

### Terms of reference for the monitoring of the transit of natural gas through Ukraine

With a view to facilitating the transit of natural gas supplied by Gazprom to its customers in the European Union, the European Commission, the Government of Russia and the Government of Ukraine agree to establish, with immediate effect, a monitoring mechanism to immediately start to observe the transit of gas through Ukraine.

The function of monitoring mechanism shall be conducted by the International Commission with the following composition: European Commission and its experts, Ministry of Energy of the Russian Federation, Ministry of Fuel and Energy of Ukraine, JSC Gazprom, NJSC Naftogaz Ukrainy and the European companies, consumers of the Russian natural gas, including: GdF Suez S.A (France), E.ON Ruhrgas AG, WINGAS GmbH (Germany), RWE Transgas a.s. (Czech Republic), SPP a.s. (Slovakia), EconGas GmbH (Austria), ENI SpA (Italy), FGSZ Ltd. (Hungary), EAO Sofiagaz (Bulgaria), Public Gas Corporation of Greece (Greece), JSC Moldovagas (Moldova), and also Statoil Hydro (Norway) and Société Générale de Surveillance.

The European Commission, the Government of the Russian Federation and the Government of Ukraine, together with their relevant companies, shall designate their expert monitors, no more than 25 each and shall inform each other of their designations.

The monitors shall collect data on the flow of gas at the below mentioned locations in Ukraine and Russia and the members states of the European Union, shall make this data available for official purposes to the European Commission, to the Government of Ukraine and to the Government of the Russian Federation.

The parties guarantee complete and unrestricted access of monitors to all relevant institutions, including:

- on the territory of Ukraine: the underground storages of gas and the following metering stations: Orlovka, Tekovo, Beregov, Uzhgorod, Drozdovichi;

- on the territory of the Russian Federation the following metering stations: Sokhranovka, Sudja, Pisarevka, Valujki, Platovo;
- on the territory of the EU countries bordering Ukraine and to the information needed to ascertain the flow of gas from Russia through Ukraine to the countries of European Union, for as long as needed. A certified copy of these Terms of Reference shall be sufficient proof for granting access.

Information gathered by the monitors, received at the metering stations, shall be transmitted in real time to competent bodies in Brussels, Moscow and Kiev.

The Ukrainian and Russian authorities shall facilitate, and in no way hinder, the work of the monitors throughout their stay in Ukraine and the Russian Federation and on the territory of the European Union member states.

All financial expenditures connected with the activities of the monitors shall be covered by the sending sides.

The Parties agreed to establish a Protocol setting out the more detailed terms of reference for an "International Expert Commission" on transit of natural gas through the territory of Ukraine as soon as possible. These agreed Terms of Reference shall at least cover:

- control of performance of transit obligations for natural gas through the territory of Ukraine;
- monitoring of the technical state of the gas transport system, including underground gas storage located in Ukraine, where relevant to the transit of gas to the European Union; and
- other issues, such as the elaboration of recommendations and proposals on optimization of transit of natural gas through the territory of Ukraine,
- monitoring on gas metering stations on the territory of Russia, located at the entry points to the GTS of Ukraine and control of the metering stations on the territory of European Union member states bordering Ukraine.

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Source: [http://www.gazprom.ru/news/2009/01/121800\\_33574.shtml](http://www.gazprom.ru/news/2009/01/121800_33574.shtml)

## **Appendix 2. Working meeting between President Dmitri Medvedev and Deputy Prime Minister Igor Sechin, 16 January 2009, Gorky, Moscow Region**

*Excerpts from the discussion*

**Dmitry Medvedev:** Igor Ivanovich, let's talk about the gas issue. How are we doing on supplying European consumers with Russian gas?

**Igor Sechin:** Dmitry Anatolyevich, Gazprom keeps trying to get this gas moving and has confirmed the volumes required by Western consumers, especially the most affected countries, those in the Balkans and Slovakia. But this gas is still not being pumped by the Ukrainian side.

Moreover, according to information we received today from Kiev, efforts to implement your proposal on gas

swap operations aimed at maintaining the priority needs of Moldova and Slovakia have also not been successful.

President of Slovakia Ivan Gaľparovič has gone to Kiev and tried to persuade the Ukrainian side to take part in the gas swap, as has the Prime Minister of Moldova, Zinaida Greceanii. But our Ukrainian colleagues maintain that such operations are impossible, despite the information sent to Gazprom by Deputy Chairman of Naftogaz of Ukraine concerning the feasibility of conducting such operations.

**Dmitry Medvedev:** That is inexplicable.

I spoke yesterday with the President of Ukraine and reiterated the urgency of getting gas to the countries that have suffered the most from the closing of Ukraine's gas pipes - Slovakia, Bulgaria and Moldova. I pointed out that these gas exchange operations, the so-called swaps, could be implemented so that Ukraine could send them its gas and our gas would arrive in Ukraine.

And in a conversation with the President of Ukraine, he told me that they would look into this issue. The fact that they have refused confirms an indisputable fact that they are thinking primarily about their own interests, about satisfying their own consumers, and not giving any thought to transit or other functions.

Another issue that I raised during my conversation with the President of Ukraine was the creation of a consortium of European companies with temporary rights to the gas that must be put into Ukraine's pipelines so that its gas transmission system can get back to its normal pressure, something which would in turn enable Ukraine to begin normal gas transportation. I suggested this to the Ukrainian President but he did not give me an answer.

**Igor Sechin:** Your proposal has been supported by the largest European producers and consumers of gas. As you know, yesterday the Prime Minister of Russia met with the head of the Italian company ENI. Today in Berlin discussions with the heads of these companies are continuing and we have been informed that E.ON Ruhrgas, Gaz de France, ENI, WINGAS and supposedly OMV, an Austrian company, are interested in participating in the consortium.

**Dmitry Medvedev:** Good.

.....We need to perform our duties properly just as the contract stipulates – to sign these contracts in a timely fashion and pay for them on time.

If this does not happen we must think about a new mechanism to protect our interests and those of European consumers. In this connection, of course we need to think about and pay attention to the possibility of increasing the capacity of both North Stream and South Stream because we cannot be so dependent on a transit state, with all due respect to the people who work there.

*Source:* [www.kremlin.ru](http://www.kremlin.ru)

### **Appendix 3.**

#### **Press conference of Prime Ministers Putin and Timoshenko, Moscow, 17 January 2009**

##### *Extracts*

**Vladimir Putin** said: “In the very near future, transit – and the Ukrainian side has assured us to this effect – will resume.”

**Yulia Tymoshenko** said that the two countries’ energy companies, Gazprom and Naftohaz, had been instructed to draw up the relevant contracts by Monday.

“Immediately after all the documents on the transit and purchase of gas are signed, all the routes for gas transit and gas supplies to Europe will be restored,” she said.

**Vladimir Putin** said: “We agreed that in 2009 our Ukrainian partners will have a discount of 20% on condition that the preferential tariff for piping Russian gas to European consumers through Ukraine in 2009 remains in force and that the price for piping will be the price of 2008”.

“We also agreed that from 1 January 2010 we will entirely move to price and tariff formation fully in accordance with European standards without any exemptions or discounts as regards both the transit and the price of gas.”

*Source:* <http://news.bbc.co.uk/2/hi/europe/7834796.stm>

#### Appendix 4. Selected Gazprom investments in the CIS and EU states

Company	State	Gazprom's share	Other shareholders	Disputes	Sector
Moldovagaz	Moldova	50% or over	35.3% Moldovan government; 13.44% Transnistria; and private shareholders	Occasional setbacks in the relations between Gazprom and Moldovan government, mostly relating to the gas price and Transnistria's gas debt; however, they have never spilled over into a major political crisis.	Gas trade
Beltransgaz	Belarus	25% (50% by 2011)	50% Belarusian government	2006 – Russia announced that it would raise the gas price for Belarus; after Belarus refused to negotiate a higher price, Gazprom suspended its gas supplies; in May 2007 an agreement was reached that Gazprom would receive a 50% share in Beltransgaz by 2011 in exchange for gradual raising of the price on Russian gas over the next four years.	Gas trade and transmission
ArmRosGazprom	Armenia	75.55%	20% Armenian government, 4.44% Itera	No major disputes	Gas trade
Lietuvos Dujos	Lithuania	37.1%	35% E.ON Ruhrgas, 34% Lithuanian government	No major disputes	Gas trade
Latvijas Gaze	Latvia	34%	16% Russia's Itera, 47.5% E.ON Ruhrgas	No major disputes	Gas trade and transmission
Europol Gaz	Poland	48%	48% PNGiG, 4% - Gas Trading	Jan 2007 – Russia demanded lower transit fees for Russian gas shipped through the Polish part of Yamal-Europe and a higher say in decision-making; Poland refused to do so on the basis of the originally established agreement of 1993; the parties went to a court and later solved the issue through negotiations.	Gas transmission
SPP	Slovakia	16.3%	51% Slovak government, 16.3% E.ON Ruhrgas and 16.3% Gaz de France	Sep 2008 – Ruhrgas and Gaz de France required Slovakia to raise its domestic gas prices by 20%. This was opposed by the Slovak Prime Minister Robert Fico, who threatened to nationalise the shares of the two Western gas companies. No disruptions followed. In 2008 Gazprom signed a contract to supply gas to the SPP until 2028.	Gas transmission
Panrusgas	Hungary	40%	50% E.ON Ruhrgas, 10% Centrex Hungaria	No major disputes	Gas trade and transmission
Overgas Inc.	Bulgaria	50%	50% Overgas Holding	No major disputes	Gas trade and construction of pipelines