

4 August 2014

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

Part two: contractual offtakes vs reverse flows, contractual law vs EU acquis

| By Andrey Konoplyanik, Moscow

According to ITAR-TASS, as cited by The Moscow Times on 04 July, EU Energy Commissioner Günther Oettinger on 03 July asserted EU companies' right to sell Russian gas, which they buy from Gazprom at the delivery points within the EU, back to Ukraine. Energy companies in the EU have an "absolute right to dispose of gas bought from Gazprom at their discretion, including delivering in the reverse to the Ukraine," Oettinger said via his spokeswoman Sabina Berger. Gazprom CEO Alexei Miller said the previous week that his company could retaliate against EU companies if they were to sell its gas back to Ukraine through large-scale reverse gas flows. "If we detect a reverse flow on gas-measuring stations in Europe, we may impose restrictions", Miller said, ITAR-TASS reported. President Vladimir Putin supported Miller's position on 01 July, although unlike Miller, Putin said that Ukraine was already taking gas intended for the EU. "In essence, [Ukraine] is getting our gas and they are paying one of our Western partners in Europe, who are not receiving these volumes," Putin said. "We see everything, but are not taking any kind of action at the current moment so as not to aggravate the situation".

Let's once again look into legal, economic and financial aspects of the "Ukraine gas reverse flows" issue and let the reader again decide whether this will be another instance of "Russian propaganda", like Mr. Obama has said, or not (see EER, 19 June issue). And while bearing in mind the above-mentioned citation of Mr. Oettinger about "absolute right" of Western companies "in delivering ... of gas bought from Gazprom ... in the reverse to the Ukraine", let us also bear in mind the famous phrase about the limits of "absolute rights" that has been ascribed to many famous persons like Winston Churchill, Immanuel Kant, Michael Bakunin, etc., that "The right to swing my fist ends where the other man's nose begins", though I prefer it in the phrasing as presented in Art. 4 of the French Convent's Human and Civil Rights Declaration (*Déclaration des Droits de l'Homme et du Citoyen*) of 1789: "*La Liberté du citoyen finit où la Liberté d'un autre citoyen commence*" (The liberty of one citizen ends where the liberty of the other citizen commences).

Ukraine Government disagrees with the levels of gas import prices which resulted from a move - initiated by this country itself (and implemented in two steps – in 2006 and 2009) - within Russian-Ukraine gas trade to 'European formulas' in Groningen-type long-term (2009-2019) gas export supply contract (see EER, 19 June

But this understandable economically and legally motivated search for multiple supplies has led to violation of the Russia-Ukraine 2009-2019 contract both in volumetric and payment terms

issue). This has led to the natural motivation of Ukraine to search for alternatives for Russian gas as its current single external source of import supplies while domestic Ukrainian supplies are inadequate to cover the country's gas needs. But this understandable economically and legally motivated (see below) search for multiple supplies has led to violation of the Russia-

Ukraine 2009-2019 contract both in volumetric and payment terms. And reverse flows are one of the parameters of this violation which creates a legal and economic dilemma to be solved by negotiations (based on clear and, hopefully, common understanding of the economic, financial and legal picture) and not by the sharp political statements of the parties involved or their unilateral actions.

Ukraine's motivation to diminish its dependence on Russian gas is based on economic interest and (since recently) on legal obligations as well!

Its economic interest results from (a) high level of Gazprom's import prices (independent of its "European formula's" origin) compared to lower gas price levels which one can see elsewhere in the EU/world, though in

quite different market environments (which creates the illusion that gas for Ukraine is unjustifiably expensive), and (b) Gazprom's justified unwillingness to move away from these 'European formulas' (though accompanied by its readiness to provide price concessions to Ukraine from these formula-based prices) – this state-controlled company (the Russian state is its controlling stakeholder with 50.23% of the stocks) is looking for the highest possible – though marketable - resource rent which is supported by provisions of international law protecting state sovereignty on natural resources. This, in turn, stipulated Ukraine to search for solutions both on the supply and demand side.

On the supply side, alternatives to Russian gas have been searched for simultaneously in/among multiple ways/possibilities: in increase of domestic production, both onshore and offshore, development of shale gas, LNG import, stipulation of reverse flows, extended use of underground gas storage (UGS) facilities, etc. – in everything that will/might make gas supplies to Ukraine multiple and competitive (an increase in gas-to-gas competition). On the demand side, deviation from gas (to be understood/read as deviation from Russian gas) is searched for by means of switching to coal and nuclear energy in electricity production, and in energy saving and improving energy efficiency in energy use – all aimed at increasing gas-to-non-gas competition.

So, development of gas reverse flows is one of the economically motivated ways and means for Ukraine to diminish its dependence on Russian gas. For this, of course, technical preconditions need to be developed since in USSR times, when the export-oriented gas transportation system (GTS) through Ukraine was developed, and further on, after collapse of the USSR until today, this GTS was aimed at supplying gas from the East (Russia and Central Asia) to the West and it was not envisaged that it should have reverse flow capacities at its interconnection points, at least with its Western neighbours.

And here the first group of economic problems has arisen, and not between Russia and Ukraine, but between Ukraine and its Western neighbours, e.g. Slovakia, related, inter alia, to the question who will pay for the development of reverse capacities. In April of this year Slovakia was ready to invest in developing physical reverse flows capacity which will cost it about 20 mln USD but would like to receive the long-term offtakes guarantees from Ukraine (which are necessary to guarantee pay-back of the investments into new capacity) which the latter was not ready to provide. And according to 'economy of scale' principles (to make pay-back period shorter/economically justifiable), Slovakia has asked Ukraine for large-scale offtake obligations of at least of 10 BCM which Ukraine was again not ready to provide. So one of the aspects of the reverse flow capacity is its investment aspect: who will pay for it and how the money will be paid-back.

And here the first group of economic problems has arisen, and not between Russia and Ukraine, but between Ukraine and its Western neighbours, e.g. Slovakia, related, inter alia, to the question who will pay for the development of reverse capacities

In this regard the issue of low (to put it mildly) payment discipline of Ukraine within the supply contract with Gazprom became immediately a valid issue for its Western neighbours aiming to invest in gas reverse flow capacity: whether Ukraine would wish and would be able to provide regular payments for reverse flows to its Western neighbours despite its long non-payments for Russian gas...?

But when/if reverse capacities are in place, another economic problem – much larger than the one mentioned above – arises. And this second one, in my view, is a key economic problem between Russia and Ukraine in regard to reverse flows.

As mentioned, Ukraine intends to use reverse flows (from the West) not in addition to, but instead of gas flows from the East (from Russia, provided by the 2009-2019 gas supply contract). This means that implementation/increase of reverse flows by Ukraine automatically leads to (since is aimed at fulfilling this task) diminishment of contractual offtakes by Naftogaz within its supply contract with Gazprom. Due to different reasons, such offtakes have diminished in 2013 to about 12.9 BCM compared to the 41.6 BCM of 'take-and/or-pay' (TOP) contractual obligation between the two.

But contractual supply obligations are mutual: the importer is obliged to offtake and the exporter is obliged to supply contractual volumes with penalties on either side if one of the parties does not fulfil its contractual obligations, including those regarding volumes. This means that in order to make the contractual volumes available the exporter shall invest, usually well in advance of the contractual delivery date, into upstream gas

contractual supply obligations are mutual: the importer is obliged to offtake and the exporter is obliged to supply contractual volumes

to develop corresponding production and transportation facilities, and on top of this, bearing in mind the remote areas where Russian gas is produced, to invest into development of macroeconomic infrastructure (and thus to add these expenses to project costs) to be able to fulfil contractual supply obligations. These production costs and

(at least additional – to bring the new gas into the GTS) transportation costs are huge, bearing in mind distances, severe conditions of gas production, etc. in Russia. So unilateral diminishment of factual and/or intended contractual offtakes by the customer (Naftogaz), inter alia, by means of reverse flows, leads to the huge economic losses of Gazprom and the Russian state due to decrease of revenue flows to pay-back earlier made upstream investments.

This situation is very similar, in economic terms, to the story of the Nordstream-OPAL pipelines where investments made in the two aren't being paid back adequately (though for administrative reasons) since only 50% of the OPAL capacity is allowed to be used by the European Commission. But in Ukraine's case the situation is even worse since only about 30% (12.9 / 41.6) of the TOP contractual capacity was used, thus diminishing the exporter's revenues flow correspondingly.

But there is also another facet which has rarely been mentioned until today – namely, that due to recent developments Ukraine has legal obligations to de facto move away from Russian gas following its accession to the Energy Community Treaty.

On its move towards Euro-integration (which Ukraine started with regards to energy in 2004), the country became a Contracting Party to the Energy Community Treaty (the Treaty). Its tasks and obligations under the Treaty break down to three distinct tiers to be implemented within Ukraine: (1) Extension of the *acquis communautaire* within Ukraine, (2) Mechanism for operation of Network Energy Markets, (3) Creation of a Single Energy Market, - both (2) and (3) to be based on the emerging EU legislation. The Energy Community *acquis communautaire* consist today of roughly 20 legal acts which include key EU legal acts in the energy area – including Third Energy Package documents. The Treaty envisages that the main principles of EU competition policy are also applicable.

Ukraine officially acceded the Energy Community on 1 February 2011 and since then is obliged to fulfil EU legal obligations, including providing for alternative supplies, like those presented in EU Regulation 994/2010 such as, inter alia, at least three alternative gas supply sources for each member state, so-called 'N-1' rule, etc. Art 6.5 of this Regulation specifically mentions reverse gas flows by saying: "The transmission system operators shall enable permanent bi-directional capacity on all cross-border interconnections between Member States as early as possible and at the latest by 3 December 2013, except: (a) in the case of connections to production facilities, to LNG facilities and to distribution networks; or (b) where an exemption has been granted in accordance with Article 7. By 3 December 2013, the transmission system operators shall adapt the functioning of the transmission systems in part or as a whole so as to enable physical gas flows in both directions on cross-border interconnections".

This means that since that date Ukraine has a legal obligation (as the Contracting Party to the Energy Community Treaty) to possess reverse flows at its Western border – at the interconnection points with the EU member states (like Poland, Slovakia, Hungary, Romania) and Moldova (which became a Contracting Party to the Treaty on 01 May 2010).

And this creates, in my view, a major legal problem regarding reverse flows – a conflict between contractual law and public law obligation of Ukraine in regard to different types of gas supply flows. What is important to remember in this regard: the contractual law obligations for Ukraine were established much earlier than conflicting public law obligations.

And this creates, in my view, a major legal problem regarding reverse flows – a conflict between contractual law and public law obligation

"Pacta sunt servanda" – and this means that contractual provisions of the Russia-Ukraine 10-year-long gas supply contract signed on 19.01.2009 shall be implemented in full, including its contractual volumes obligations, i.e. offtake volumes by the customer due to the reasons explained above. Two years later (in

February 2011) after the contract was signed, Ukraine became a Contracting Party to the Energy Community Treaty, and almost three more years later (in December 2013) a new public law obligation – to “enable permanent bi-directional capacity on all cross-border interconnections between Member States... so as to enable physical gas flows in both directions” - has emerged for Ukraine as a result of its membership of the Treaty. This means that public law obligations were established for Ukraine almost five years after the 2009 Gazprom-Naftogaz gas supply contract has come into effect. This is a specific legal conflict between two pieces of international legislation (contractual and public law) which have provided conflicting obligations with different enforcement dates for the parties. This legal issue can/shall be further discussed by the legal experts of the parties and in the broader international community, but as for me, the prevailing obligation in this debate is the earlier contractual obligation for, inter alia, specific offtake volumes.

This legal view has, in my view, strong economic justification as was presented above.

And the final point for this Opinion: one should distinguish between 'physical' and 'virtual' reverse flows since it is considered by some that available unidirectional gas flows (like that of Russian gas through Ukraine) provide an opportunity for virtual reverse flows by the transmission system operator (TSO, in this specific case - Naftogaz) without even involving a supplier. In my view, this will be equivalent to another form of unauthorized gas acquisition, since gas in the pipe in Ukrainian GTS in transit through the country belongs to Gazprom until it reaches delivery points deep inside the EU further West from Ukraine. Accession of Ukraine to the Energy Community Treaty has raised once again the issue of virtual reverse flows based on the interpretation (perception) of some market participants (including the Commission) as if EU energy *acquis* requires/demands/predetermines/mandates virtual gas flows.

European Court of Justice has dropped a curtain in this debate by issuing on 05.06.2014 its Judgment in Case C198/12 'European Commission vs Republic of Bulgaria' regarding virtual gas flows. The Court finds that none of the provisions in EU legislation (namely, in the Third Energy Package and, in particular, in its Regulation 715/2009 which Commission referred to in this Case) expressly establishes an obligation to provide virtual reverse flow gas transmission capacity. So the Court has disagreed with Commission's arguments and has fully supported Bulgaria in this dispute and has dismissed the Commission action.

To summarize the above: any unilateral actions regarding reverse gas flows in Ukraine creates economic and/or legal problems to be solved by the parties in question and/or in multilateral international debate.

In the next Opinion (to follow) I would address the comparative issues of bringing the Russian gas to the EU through Ukraine, including the prospects of gas transportation consortia, and/or using alternative routes by-passing Ukraine, both to the North-Western and Southern Europe.

Dr. Prof. Andrey Konoplyanik is an Adviser to Director General, Gazprom export LLC, and Professor at the Chair "International Oil & Gas Business", Russian State Gubkin Oil & Gas University (www.konoplyanik.ru).

All rights reserved. No part of this publication may be reproduced in any form without written consent from the publisher. For inquiries please contact europeanenergyreview@elektor.com.