

DIXI GROUP ALERT:

THE PROTOCOL ON RUSSIAN GAS TRANSIT FIXED COMPROMISES BUT RAISED ADDITIONAL QUESTIONS

On December 21, the Government of Ukraine [made public](#) the protocol signed by representatives of the EU, Ukraine and Russia as well as companies of these countries (Gas Transmission System Operator of Ukraine LLC, NJSC “Naftogaz of Ukraine”, Gazprom PJSC).

The document sets out the parties' **coordinated political agreement** on the conditions of Russian gas transit through Ukraine from January 1, 2020. This arrangement is to be implemented by companies that need to enter into relevant agreements.

Inter alia, the protocol provides for the following decisions:

- 1) Gazprom and Gas Transmission System Operator of Ukraine LLC will conclude an interconnection agreement;
- 2) Gazprom and NJSC “Naftogaz of Ukraine” will conclude a contract for the organization of gas transit; Naftogaz as the “organizing company” will enter conclude a transit contract with Gas Transmission System Operator of Ukraine LLC (on the basis of an amended Model Gas Transmission Contract);
- 3) Naftogaz as the “organizing company” will book capacity for transit at 65 bcm (2020) and 40 bcm (2021 to 2024) per annum, but subject to the setting of a “competitive tariff” by the NEURC, which will be recognized by Naftogaz and correspond to the tariffs in the countries of Western and Central Europe;
- 4) possibility to continue transit in 2025-2034 under similar conditions;
- 5) a “package” dispute settlement arrangements, in particular:

- ▶ Gazprom's payment of app. 2.9 bn USD under decisions of the Stockholm Arbitration;
 - ▶ withdrawal by Naftogaz and Gazprom of all arbitration claims with no final decisions made (including claims by Naftogaz for 12.2 bn USD and 1.33 bcm);
 - ▶ withdrawal of seizure of Gazprom's property and assets;
 - ▶ waiver in the future of possible claims and lawsuits under the 2009 gas contracts;
 - ▶ conclusion of irrevocable amicable agreement in the arbitration on the Antimonopoly Committee penalty (85.9 bn UAH), termination by Ukraine of all current and possible future requirements based on the respective AMCU decision
- 6) the NEURC will amend the Model Gas Transmission Contract to bring it in line with the agreement between Naftogaz (organizing company) and Gas Transmission System Operator of Ukraine LLC;
 - 7) obligations of the parties (Ukraine, Russia and the European Commission) to ensure implementation of the mentioned agreements;
 - 8) following implementation of the agreements – the possibility to resume direct gas supplies by Gazprom to Ukraine, taking into account the pricing based on NCG hub price and a reasonable discount (based on the volume of such supplies).

ADVANTAGES

1) The conclusion of interconnection agreement will allow Ukraine to:

- ▶ apply the EU law, in particular Commission Regulation (EU) 2015/703, in practice;
- ▶ open the possibility for European companies to book capacity of the Ukrainian system with the gas transfer point at the border with Russia;
- ▶ demand from Russia the demonopolization of pipeline exports, free third party access to interconnections.

2) 5-year transit with the possibility of prolongation for another 10 years is a “draw” (the Ukrainian party aimed a 10-year deal) but the best of the achieved opportunities which will allow:

- ▶ guaranteed payment for the minimum capacity specified in the agreement;
- ▶ possibility of additional booking of capacities for short term;
- ▶ applying a higher tariff (at the level of tariffs in the countries of Western and Central Europe);
- ▶ long-term planning of system development;
- ▶ stable prices in the gas market of Ukraine.

3) Gazprom’s recognition of the Stockholm Arbitration awards on 2009 gas transit and supply contracts will allow:

- ▶ receiving a proper payment of app. 2.9 bn USD, including penalties and fees;
- ▶ fixing the European principles in contractual relations and strengthening them in the gas market of Ukraine;
- ▶ “turning the page” of 2009 contracts by waiver of all possible future claims and lawsuits.

4) The transition to cooperation under European rules will allow:

- ▶ splitting the issues of gas transit and supply that Gazprom tried to include in a ‘package’ deal;

- ▶ continuing the gas market reform in Ukraine, applying the EU law to relations with Gazprom and other system users;
- ▶ unblocking the interconnection points with the EU Member States, where Gazprom acted as the “virtual operator”, and gradually achieve full compliance with the EU rules on interconnection agreements at all points.

RISKS

1) The annual guaranteed transit of 40 bcm in 2021-2024 may not be sufficient for the profitable TSO activity and development of the system designed for three times larger volumes

- ▶ The precondition for such guaranteed volumes is the setting of a “competitive tariff” by the NEURC, which will be recognized by Naftogaz. At the same time, with the reduction of transit volumes, an increase in tariff can be expected (given the system fixed costs), having unclear consequences if Naftogaz disagrees with the transmission tariff.
- ▶ In the event of such low volumes of transit, the system will operate at minimum level of profitability, and the tariff may increase to a level when it becomes not competitive with Gazprom’s tariff on bypassing pipelines (e.g., completed Nord Stream 2), which will result in even less attractiveness of the Ukrainian route.

2) Naftogaz, as the “organizing company” of transit is actually an intermediary between Gazprom and TSO, and such role may have unpredictable consequences.

- ▶ This scheme of booking transit capacity is not typical for the European market, where the capacity is booked directly by owner (shipper) and the mechanisms for transferring such rights are applied only in the secondary market. It is unclear whether the agreement between Naftogaz and Gazprom will actually include the transfer of property and other rights, or whether it will be similar to agency agreement on the provision of certain services.

- ▶ The reason for Naftogaz participation was mentioned by some Ukrainian negotiators - the fact that Gazprom is not ready to assume all the risks of the Ukrainian legislation and regulation. At the same time, in cooperation with European TSOs, which are also subject to dynamic change of regulations, Gazprom - for some reason - is ready to assume such risks.
 - ▶ There may be a significant discrepancy in the tariff set by the agreement between Gazprom and Naftogaz and the gas transmission tariff set by the Regulator (to be used in the standard contract between Naftogaz and TSO). In this case, depending on the difference, all the risks and losses will be borne by either Naftogaz or TSO, which may adversely affect the financial condition of the companies.
- 3) Cancellation of all current and possible future claims based on the decision of the Antimonopoly Committee may complicate further investigations against Gazprom
- ▶ The 2016 AMCU decision recognized Gazprom as the one having a monopoly (dominant) position in the market of services of gas transit by main pipelines in the period from 2009 to 11 months of 2015. The waiver of claims on this decision may create a precedent, with Gazprom effectively appealing any future AMCU investigations.
- 4) The agreement to withdraw all arbitration actions and lawsuits on which final decisions have not been made can be treated by the Russian party quite broadly; and additional requirements may be imposed on Naftogaz
- ▶ Representatives of the Ukrainian party have already stated that the withdrawal of lawsuits will not apply to the lawsuit on Naftogaz assets in Crimea, since the state (Russian Federation), and not Gazprom, is the defendant.
 - ▶ However, the Russian party may use the lack of clarity on these arrangements to disrupt their implementation.
- 5) Agreements generally unblock direct supplies of Russian gas to the Ukrainian market; with no restrictions on imports, it could have economic and political consequences
- ▶ The mass media reported at least 5 companies have entered into gas supply contracts with Gazprom from January 1, 2020; however, the Russian party has denied these reports. The resumption of direct supplies may have both positive (higher competition, lower wholesale prices, especially for industrial consumers) and negative (lack of diversification, loss of European companies' interest) impact on the market.
 - ▶ The political consequences of increasing trade with the aggressor country include both a weakening of the international sanctions regime and possible changes in the political situation in Ukraine. Through its pricing policy, Gazprom - as a tool of the Kremlin's foreign policy - can "reward" loyal and "punish" disloyal industrial groups in Ukraine, and influence Ukrainian politics. It was under the pressure of the industrial lobby that the government once made political concessions to Russia, exchanging lower gas prices for the 25-year lease extension for Russian navy in Crimea ('Kharkiv Accords') and for refusal to sign the Association Agreement.

DIXI GROUP RECOMMENDATIONS

Given the dynamics of future negotiations, DiXi Group think tank considers it reasonable to make the following **recommendations**:

- ▶ Naftogaz should include in the agreement on transit organization with Gazprom a) a clear list of rights and obligations transferred, b) a tariff/fee based on formula (similar to the one used in the Methodology for the Calculation of Tariffs for Natural Gas Transmission Services), not in absolute numbers;
- ▶ Naftogaz and Gas Transmission System Operator of Ukraine LLC in contracts with Gazprom should provide for a guaranteed volume of transit, with fixed minimum volumes and benchmarks for the volumes of additional transit (flexible, short-term capacity products);
- ▶ While calculating tariffs for Gas Transmission System Operator of Ukraine LLC, the Regulator should take into account two scenarios for 2021-2024 – one with a minimum guaranteed volume of 40 bcm, another with maintaining 65 bcm;
- ▶ The Cabinet of Ministers and the AMCU, when entering into an amicable agreement with Gazprom, should determine that it is related to specific case and does not create a precedent for any future investigations on suspected anticompetitive actions;
- ▶ The Cabinet of Ministers, the Verkhovna Rada, and the National Security and Defense Council of Ukraine should, for energy security purposes, consider the possibility of imposing trade restrictions on gas imports from the Russian Federation from January 1, 2020, which may vary from a direct ban (embargo) to setting annual quotas for at least 30% of total gas imports to Ukraine and a mechanism for adequate allocation of quota among applicants.