

## QUICK POLICY INSIGHT

# Delays to South Stream benefit Ukraine

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At an event held at the European parliament on 4 December 2013, the European Commission Director for energy markets described the international agreements underpinning the planned Russian South Stream gas pipeline as illegal<sup>1</sup>. This declaration, which was [publicly confirmed the following day](#), comes at a moment of rising tensions between the EU and Russia.

The standoff has been exacerbated by Russia's role in the Ukrainian government's recent decision not to pursue an Association Agreement, including a deep and comprehensive free trade agreement, with the EU. The EU's pronouncement on South Stream is likely to be welcomed by Kyiv, which has been deeply concerned about losing its status as a gas transit state from Russia to the EU. The South Stream project, which has been under construction since December 2012, would have allowed Russia to bypass Ukraine, delivering gas to south-western Europe through lines under the Black Sea (see *Figure 2*). Once completed, Ukraine would lose the much-needed income it derives from transferring Russian gas westwards, and Moscow could potentially cut off gas to Ukraine without disrupting its European supply.

The Commission has made previous proposals to allay Kyiv's fears, even [promising to develop a new pipeline to Ukraine from Slovakia](#) to reduce Ukraine's dependency on Russian gas. For its part, Moscow has also made offers to Ukraine, particularly when it appeared that Kyiv was prepared to sign the Association Agreement. In addition to a discount on Russian gas, Moscow promised a one-year extension on Ukraine's

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<sup>1</sup>According to the Commission, intergovernmental agreement between Russia and Bulgaria, Serbia, Hungary, Greece, Slovenia, Croatia and Austria are to be renegotiated. See also [South Stream bilateral deals breach EU law, Commission says](#), on Euractive, 5 December 2013.

repayments to Gazprom (the total debt being valued at USD 1.3 billion).

The Commission's most recent move would not halt South Stream construction in the partner countries – Bulgaria, Serbia, Hungary, Greece, Slovenia, Croatia and Austria – but is likely to create delays of at least two years and to make financing more difficult.

The EU has based its evaluation on the project's failure to respect the Union's third energy package, a set of laws intended to open up the European energy market. The South Stream project is said to violate the package because: (1) Gazprom is owner of both the transmission network and the gas to be exported; (2) Gazprom has not allowed third parties non-discriminatory access of to the pipeline but has remained the sole shipper; (3) the proposed tariff structure – and in particular the link between oil and gas prices – is not in line with European law.

## Ukraine, Russian gas and alternative pipelines

Ukraine needs Russian gas for its domestic consumption and for the revenues it provides.

The Nord Stream and South Stream pipelines would circumvent Ukraine, cutting down on the country's much-needed income and making it more vulnerable to Russia's cuts.

Ukraine is entirely dependent on Russian gas for industrial and domestic consumption. The country also receives substantial – and badly-needed – income for Russian gas transiting through its territory to Europe ([USD 3.2 billion in 2011](#)). The supply has not proven entirely reliable, however: in 2006 and 2009, Russia cut off supplies of gas to Ukraine and launched the construction of alternative routes, the Nord Stream (reaching Germany via the Baltic sea – a project Gazprom has undertaken with BASF, E.ON, Gasunie and GDF) and the South Stream (reaching southeast Europe via the Black Sea – a project Gazprom has undertaken with ENI and EDF).

The Nord Stream has been labelled a priority by the Commission and received a loan of EUR 120 million in March 2010. Nord Stream 1 and 2 are operational and bring 55 bcm (billion cubic meters) to Europe annually. Nord Stream 3 and 4, which are planned but not complete, will double this capacity.

Less gas has already transited through Ukraine as a result of Nord Stream. The first Nord Stream line opened in 2011, and the amount of gas passing through Ukraine declined by 24 % between the first half of 2011 and the first half of 2012.

**Figure 1:**  
Nord Stream



The Commission has long sought alternatives for South Stream, although Nord Stream has received funding and approval.

South Stream's alternatives will not deliver nearly as much gas.

While South Stream would likely have a similar effect on Ukraine, progress on its line has been less smooth. Before the Commission declared South Stream illegal, it had tried to replace – or at least supplement – the South Stream with an alternative southern corridor that would bring Azeri gas to the European market. The EU initially pledged EUR 250 million to support this 'Nabucco' pipeline, which would cross Turkey, Bulgaria, Romania and Hungary and be supplied by various sources. Since then, the project has been replaced by another: in July 2013, [the Azeri consortium Shah Deniz II](#) (and its partner BP) chose to pursue the less expensive Trans Adriatic Pipeline (TAP). (TAP will bring gas to Italy after crossing Turkey, Greece and Albania; the line will be open only to Azeri gas supplies and will not receive public resources.)

Yet none of the alternative projects has reduced the potential importance of South Stream. TAP will bring only 10 bcm to Europe, while the four lines of South Stream will provide 63 bcm. Despite the relatively modest scale of the Azeri project, it too is likely to benefit from the Commission's investigations into South Stream: any delay to South Stream will benefit TAP.

**Figure 2:**  
South Stream  
(possible route)



Source: M. Hafner, *Russian Strategy on Infrastructure and Gas Flows to Europe*. POLINARES working paper n. 73

## Political and economic implications

Ukraine needs cash, and is unlikely to receive more from the International Monetary Fund.

Moscow is likely to make a tempting offer.

While the EU reportedly offered less than Ukraine requested, some analysts consider the delay to South Stream a way to entice Kyiv.

Some observers have clearly linked the Commission's declarations on South Stream to the ongoing political turmoil in Ukraine, triggered by Kyiv's last-minute refusal to implement the necessary reforms for the Association Agreement to be signed. In this analysis, the EU is responding to cash-strapped Ukraine's recent pleas for more funding.

[Analysts believe that Ukraine needs at least EUR 10 billion](#) to stabilise its fragile domestic finances and avoid a default in 2014. The International Monetary Fund (IMF) has loaned the country money, but its conditions have yet to be met, meaning the institution is unlikely to offer Kyiv another bailout. Ukraine may well perceive Russia as its best source of funding; Moscow is reported to have offered Ukraine USD 15 billion and reduced the gas prices of long-term contracts. (Moscow has denied this.) Russian President Vladimir Putin and Ukrainian President Viktor Yanukovich are meeting on 17 December to discuss the terms of the deal.

Ukrainian Prime Minister Mykola Azarov has also requested [EUR 20 billion](#) in aid from the EU, which he said would offset the cost of Russia's trade retaliation measures. The EU reportedly offered Ukraine EUR 610 million at the recent Eastern Partnership summit held in Vilnius. While this is clearly far less than Vilnius has requested, some perceive the Commission's recent move on South Stream as an additional effort to woo Ukraine towards the EU; any delay in South Stream would represent a significant financial boon for the EU's recalcitrant Eastern partner.

The European Commission has denied it is engaged in such 'horse-trading'<sup>2</sup>, although the timing of the recent announcement leaves many in doubt.

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<sup>2</sup> In fact 10 Billion would be enough for macroeconomic restructuring, but still much more than EU offered, see <http://www.oxan.com/display.aspx?ItemID=DB187782>