What’s Next for Natural Gas in Ukraine?

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Introduction

Ukraine and Russia signed a new contract for transit of natural gas on December 30, 2019—just one day before the previous contract expired. According to the new agreement, Russia will send at least 65 billion cubic meters (bcm) of gas via Ukraine in 2020 and at least 40 bcm during the following four years, with total transit fees exceeding $7 billion. The contract came on the heels of Gazprom’s $2.9 billion payment to Ukrainian Naftogaz that followed an earlier ruling by the Swedish arbitration court, while Ukraine dropped additional claims against the Russian gas giant.

However, Ukraine’s relations with Russia are far from a rapprochement. To begin with, no Russian gas has flown to Ukraine since 2015, and there are no plans for restoring flows. In addition, the natural gas transit agreement can be hardly viewed as Russia extending an olive branch. The agreement’s short time frame and low transit volumes point instead to necessity as completion of Nord Stream 2 (NS2) – an alternative to Ukrainian transit – faces likely delays of at least one year due to US-imposed sanctions. Vying for funds received from transit of Russian gas, Ukraine continues eagerly to look to the West — including European Union (EU) member states and the United States (US) — for support.

What is the future of natural gas in Ukraine? The answer is far from unequivocal and will depend on the way the country deals with the challenges and opportunities that it faces. The potential opening is even more remarkable when one considers that just last year the country completely overhauled its government. In April 2019, Ukraine elected Volodymyr Zelensky, a former actor and comedian and a political novice, as its president. In July’s snap parliamentary elections, Zelensky’s power was consolidated when his nascent party – Servant of the People – won an outright majority of seats in the parliament. It was the first time that has happened in Ukraine’s post-Soviet history.

Nevertheless, with great power always comes great responsibility. One of the major issues for Ukraine and Zelensky will be designing energy policy that not only fosters this country’s economy, but also sets up a more independent and market-based – rather than influence-based – relationship with Russia. Natural gas will take center stage here, as Ukraine’s traditionally heavy reliance on cheap Russian gas and transit status have been a cornerstone of Russia’s ability to influence Ukrainian politics and policy in the past.

In this context, Ukraine’s new government has pledged to overhaul the country’s energy system. Domestically, it is hoping to implement energy efficiency measures and develop new resources, including natural gas, while pledging to fight corruption and uphold market principles. It is also increasingly looking toward the EU for help, guidance and collaboration, and to the US as a potential source of foreign investment and capital.

In this paper, we consider the opportunities and challenges that such plans are likely to face.
Russia, Ukraine and Natural Gas

While today we associate Ukraine with high dependency for natural gas supply, this has not always been the case. In fact, the country has been a host to one of the largest natural gas reserves and was a major gas supplier within the Soviet Union in 1940s and 1950s. In 1949, a new pipeline was built to deliver Ukrainian gas to Moscow, Minsk (Belarus), and the Baltic Republics. Even in the 1960s, and 1970s, natural gas from Szebelskoje in the Dniprovskiy and Donetsk regions was still a major source of supply. However, toward the end of the 1970s, as some of the Ukrainian reserves became depleted, the Soviet Union decided to move natural gas extraction to Western Siberia and Central Asia as part of an effort to introduce specialization in the Soviet Union republics, including a pan-Soviet extraction industry and pan-Soviet heavy industry sector.\(^1\) As a result, Ukraine has become increasingly reliant on natural gas imports, first as part of the USSR and then as an independent country with Russia as the dominant supplier (Figure 1).

**Figure 1. Consumption and Imports of Natural Gas**

![Natural gas consumption and import in Ukraine (bcm)](image)

Source: Naftogaz Europe\(^2\)

Ukrainian dependence on imported gas has been decreasing in the recent decade or so. In 2018, imports constituted only 33 percent of Ukraine’s consumption, far from the record 84 percent in 2007 and high 70s to low 80s during the 1990s and 2000s.\(^3\) The negative trend in the volumes of imports relates without a doubt to decreasing demand for natural gas. While in 1991 Ukraine was using 118.2 bcm of gas, in 2016 the demand was only 33.3 bcm and was further reduced to 29.77 bcm in 2017 (Figure 2).\(^4\) This precipitous drop in demand can be attributed to a slow or, at times, declining economy (collapse of Soviet Union and artificial manufacturing and trade patterns were upended by open markets) and increasing prices of natural gas imports, both of which have been exacerbated by ongoing conflicts with Russia.
Russia has always been the dominant supplier to Ukraine and it held monopoly over Ukrainian gas imports between 2006 and 2012 (Figure 2). These imports have been priced at a lower than market price, a result of several tacit agreements with the Ukrainian government that would, for example, give Russia access to the Black Sea and right to establish a military basis in Sevastopol. Often, Russia was also happy to agree to a later payment as well, which resulted in Ukraine’s accumulation of significant amounts of debt and gave Russia an important point of influence over Ukrainian policymaking.

**Figure 2.** Ukraine Natural Gas Demand: Production*, Export and Import Structure Since 1990

*Domestic production shown in dark red.
Source: Vorobyov, 2016.

In addition to receiving cheap natural gas, Ukraine has also benefited from its status as a transit territory, as more than two thirds of Russian gas to Europe historically had to cross via Ukraine. (Figure 3 shows annual volumes). The substantial volumes have translated into transit fees that contributed to the Ukrainian economy, accounting for between 1.4 and 3.9 percent of the country’s total GDP and between 8 to 10 percent of the country’s budget (Figure 4).
What’s Next for Natural Gas in Ukraine?

**Figure 3. Natural Gas Transit via Ukraine (bcm per year)**

Source: Naftogaz Europe

**Figure 4. Transit Fees: Share in GDP & Budget**

Source: IMF; National Bank of Ukraine; State Statistics Service of Ukraine; Ministry of Finance of Ukraine

As important as the relationship has been for both Ukraine and Russia, it has also been fraught with conflict. Pricing disputes, debt settlement issues and policy differences led to cutoffs in supply to Ukraine and Europe in the 2005-2006 and 2008-2009 winter seasons. Russia’s invasion in 2014, annexation of Crimea and subsequent occupation of the Donbas region have further exacerbated the conflicts over natural gas supplies. As such, 2016 marked the first year without direct Russian gas imports (Figure 5). Instead, the country has been receiving gas via reverse flows from Poland, Hungary, and Slovakia. Ukraine has pledged not to go back to Russian natural gas supplies and instead to continue to rely on European imports and potentially to increase its own production. This position holds even as disputes over debt and payments between Gazprom and Naftogaz were
settled in the December agreement that extended Russian gas transit via Ukraine. That agreement notwithstanding, direct supply of Russian gas to Ukraine still has not resumed.

**Figure 5. Source of Imported Gas, %**

![Chart showing gas sources]

Source: Naftogas Europe

The five-year extension of transit contract is not much more than tentative measure. However, it gives Ukraine and its newly elected government more time to set up a new system of natural gas supply—one based on market values and possibly devoid of political or geopolitical underpinnings and dependency on Russia. To what extent these plans materialize will depend on how well the Ukrainian government is able to manage the significant challenges ahead while exploiting the opportunities that arise.

**Ukraine Natural Gas Supply: Beyond Russian Gas**

**Efficiency and Energy Savings**

Increase in efficiency and energy savings seem like a good place to start as possibly the low hanging fruit of many energy reforms.

As pointed out previously (Figure 1), Ukrainian demand for natural gas has fallen dramatically in recent years. However, this lower demand has not been related to efficiency gains. Rather it has been a result of low economic performance and post-2014 the conflict with Russia, Russian annexation of Crimea and occupation of Eastern Ukraine.

Accordingly, if the country begins to develop economically, energy demand is bound to grow. Increasing energy efficiency could and should be one of the main ways in which the growing demand could be tackled. Ukraine has a history of wasteful natural gas use at both the commercial and consumer levels that has been encouraged by access to cheap Russian gas, often additionally subsidized by the Ukrainian state. As noted by Wolczuk (2016), *Ukraine “behaved like an energy-rich state” artificially keeping prices of natural gas low, which encouraged development of high-energy intensive industry and waste. This discouraged investment and, together with high incidence of nonpayment among gas consumers, significantly burdened the Ukrainian budget.*
The burden became even more pronounced after Ukraine could no longer rely on cheap gas from Russia.\textsuperscript{11} Thus, efficiency measures would serve not only goals of energy security, they are also essential for Ukraine to grow and develop economically.

However, the goal of energy efficiency has been in stark contrast with some of the provisions of the new energy law enacted by Ukraine in 2015. First, per the law provisions, the state could require Naftogaz to sell gas to individual consumers at guaranteed/fixed prices as part of the company’s “public service obligation” (PSO),\textsuperscript{12} though this provision is supposed to be relinquished as of May 1, 2020.\textsuperscript{13} Second, the law provides for a class of “vulnerable consumers” who continue to be subsidized by the state.\textsuperscript{14} And even though 2019 brought convergence of regulated and market prices of natural gas, consumers considered vulnerable/sensitive continue to receive help, this time in the form of check or bank transfer. Meanwhile, data shows that subsidized consumers use on average twice the amount of gas than those who do not receive subsidies, which indicates that they use gas less efficiently than those paying full price.\textsuperscript{15} In addition to legal guidelines, slow advancement in metering makes individual incentives difficult to apply. Such incentives are virtually impossible to implement where typical for Ukraine communities and associations distribute heat and electricity to a broad range of consumers with no individual metering.

### Domestic Natural Gas Resources

As discussed previously, Ukraine historically was one of Europe’s top natural gas producers and, in the past, exported much of its natural gas to other parts of the Soviet Union. In the 1970s and early 1980s, the country still produced approximately 70 bcm of natural gas annually. Afterwards, Ukrainian production dropped precipitously, the result of aging of the natural gas fields and Soviet focus on production in West Siberia and Central Asia. Since mid-1980s this figure ranged within 32-38 bcm and shrunk to around 20 bcm since early 1990s (Figure 6).

#### Figure 2. Gas Production in Ukraine, 2015-2018 (bcm)

![Image of gas production chart]

Source: EPRAVDA\textsuperscript{16}
In 2019, Ukraine’s total natural gas production decreased by 1.4 percent. Ukrgasvydobuvanna (UGV) – the state-owned natural gas company responsible for more than 70 percent of Ukraine’s natural gas production in 2019 – recorded a 3.7 percent (0.5 bcm) decrease in its 2019 production. The decline can be attributed to the aging of its biggest fields: the Shebelynkske field (discovered in 1950 and now 89 percent depleted), the Zakhidno-Khrestyshchenske field (90 percent depleted), the Yablunivske field (79 percent depleted), and the Yefremivske field (82 percent depleted), and the Melekhivske field (82 percent depleted). That said, UGV’s western branch increased its production by approximately 0.75 bcm.

As of December 2019, Ukraine was home to 37 active drilling rigs, a precipitous fall from July that year when 91 rigs were active in the country. However, rather than a sign of sudden weakness, the drop is associated with UGV’s new strategy to, inter alia, focus on the most productive rigs. Thus, despite this significant drop in rig count, the amount of gas developed by UGV in 2019 was only 0.5 bcm (3.2 percent) smaller than the year before and Ukrafta as well as independent producers performed slightly better in 2019 better than they did in 2018 (See Table 1).

### Table 1. Ukrainian Gross Gas Production (2015-2019, bcm)

<table>
<thead>
<tr>
<th>Company</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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</thead>
<tbody>
<tr>
<td>Private Companies</td>
<td>3.9</td>
<td>4.2</td>
<td>4.1</td>
<td>4.4</td>
<td>4.6</td>
</tr>
<tr>
<td>Chornomornaftogaz</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>Ukrafta</td>
<td>1.5</td>
<td>1.3</td>
<td>1.1</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Ukrgasvydobuyanna</td>
<td>14.5</td>
<td>14.6</td>
<td>15.3</td>
<td>15.5</td>
<td>14.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
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<td><strong>20.1</strong></td>
<td><strong>20.5</strong></td>
<td><strong>21</strong></td>
<td><strong>20.7</strong></td>
</tr>
</tbody>
</table>

Source: EPRAVDA

However, the Ukrainian government is hoping to build up its natural gas industry to recover additional volumes to supply the Ukrainian market and, in the long term, even become a natural gas exporter. According to former Vice Prime Minister of Ukraine Volodymyr Kistion, Ukraine has about 600 billion cubic meters of proven gas reserves, of which the state is developing only 3.5 percent. According to other sources, currently Ukraine’s proven (conventional) natural gas reserves are estimated to be at about 1.1 tcm (trillion cubic meters) and according to the US Energy Information Administration (EIA), there is also the possibility of shale development as the country reportedly sits on 1.2 tcm of shale gas.

Ukraine’s former Prime Minister Oleksiy Goncharuk intended to increase gas production, pointing out that permitting procedures, e-auctions and legislation have already been simplified. Hoping to exploit new opportunities in natural gas, the Ukrainian government offered an area of 29,000 square kilometers for licensing to private companies that would develop natural gas and oil resources.

Ukraine has also made the auctions and licensing process easier for foreign investors as it does not need them to register as a company in Ukraine unless they win the auction. Additionally, the State Geological Service launched a virtual data room for geological formations in three of the blocks offered for auctions.
What’s Next for Natural Gas in Ukraine?

The eagerness of the Ukrainian government to bring in foreign investors - particularly oil and gas companies from the US - could be seen after the visit of US Secretary of State, Mike Pompeo. President Zelensky invited American companies to be part of the oil and gas development in the country, including in the Black Sea shelf.

Nevertheless, the enthusiasm of the Ukrainian government meets with a rather cautious approach by foreign investors as not all concessions received bids and no bidding wars resulted from the offerings.25 Additionally, the offshore tender was cancelled by the government, which was not happy that the winner of the tender was a small domestic company far from the likes of ExxonMobil or Shell.26 Instead, the geological service is hoping to attract large players next time around, as more time and effort are given to marketing the area through holding roadshows.27

Even so, Ukraine’s push for domestic oil and gas development and foreign direct investment (FDI) is bound to face significant hurdles going forward. To begin, the majority (62 percent) of conventional natural gas resources can be found in the Donetsk region, much of which is currently occupied by Russia. A similar situation takes place when it comes to unconventional resources, as 60 percent of this gas is located in Eastern Ukraine. In addition, the loss of Crimea is associated with the loss of 1.2 tcm, approximately 80 percent of Ukraine’s Black Sea gas endowment.28

Moreover, there is the question of transparency. The Zelensky government, which has promised to fight corruption, will have to face not only the corrupt practices at the federal level but also within state and local levels. One of such issues where the latter constitute a significant impediment is subsoil access, which according to former PM Goncharuk in Poltava, the country’s leading natural gas producing region, has been grossly mismanaged when it comes to equal access for investors.29 Thousands of suspended wells and dozens of promising fields remain undeveloped. Special permits for gas development fell into the hands of corrupt politicians and dubious companies, whose owners are not known today.30

**External Gas Suppliers (Imports)**

It will take considerable time before Ukraine is able to exploit potential domestic resources or become, as some of its policymakers hope, a natural gas exporter itself. Thus, in an immediate term, Ukraine needs to ensure diversification of its natural gas supply away from Russia. Since 2014, the country has successfully backhauled natural gas from Hungary, Poland, and Slovakia (much of which comes from Russia just now in this indirect manner). However, the country is also aware that, in case of growing demand, it will need more capacity than the current pipeline connections allow. This is why Ukraine has been actively engaging in building up infrastructure that better connects it with its neighbors, including construction of gas interconnectors in Poland or the creation of virtual trading points. This will allow Ukraine not only re-importing Russian gas (actually or virtually) but also indirectly import gas from other sources. Ukraine is in general supporting the development of the Southern Corridor that would bring Azeri gas into Southern Europe.31 It is also in the process of modernizing its border metering stations with Moldova to be able to receive gas from Romania.32 Most recently, such opportunity has been expressed in the US-Ukraine agreement where US company Louisiana Natural Gas Exports would supply 6-8 bcm yearly to Poland’s LNG terminal in
Swinoujscie to send it via Poland to Ukraine to create a natural gas hub using Ukrainian underground gas storage (UGS) facilities.\textsuperscript{33}

There is also the question of Ukraine building an LNG terminal itself. Some argue for this option as the best way to ensure Ukraine’s ability to become independent of any one supplier. However, given that any LNG shipment going to Ukraine would have to go through the Bosporus Strait, makes the LNG terminal proposition rather unlikely. Already in 2015, the Turkey announced that it would not allow passage of LNG tankers via the Strait to Ukraine citing safety issues.\textsuperscript{34} But Turkey also sees itself as a major player in the European natural gas market, a hub for Europe and therefore is likely to see an LNG terminal in Ukraine if not as competition than at least as weakening their position in the region.

Lastly, Ukraine can also rethink its willingness to bring in Russian gas. If the country market is diversified and liberalized enough, Russian gas may become an attractive option from a price perspective, not as part of long-term contracts so much as through spot purchase.

**EU-Driven Evolution of Ukraine’s Natural Gas Market**

Looking for cooperation with EU, including in the energy sector, has been a natural development for Ukraine trying to establish its sovereignty and independence from Russia. Given the political influence Russia has derived from Ukraine’s dependence on gas and transit territory status, it should come as no surprise that there have been significant forces that pushed for Ukraine’s closer ties to the EU’s energy market.

The early stages of Ukraine’s integration with the EU reach all the way to 2005 when Ukraine and EU signed the memorandum of understanding on cooperation in the field of energy. As part of this memorandum, Ukraine expressed its readiness to implement EU energy regulations and to join the Energy Community. In 2009, the EU and Ukraine signed a declaration to modernize the latter’s natural gas transit system. In 2011 Ukraine joined the Energy Community, which required the country to implement EU’s energy laws and principles (acquis communautaire) with the goal to “create an integrated pan-European energy market” by facilitating trade in electricity and natural gas through creation of a one regulatory space. According to this agreement, the EU’s laws would supersede those of Ukraine in case of conflicting provisions. This commitment was reiterated in 2014 on March 21, when Ukraine and EU member states signed an Association Agreement. The parties committed to developing cooperation in the energy sector including in energy security, infrastructure development, integration of energy markets, promoting nuclear safety, energy efficiency and renewables. Commitments also include regulatory adjustment to EU laws that most importantly includes the Third Energy Package and the unbundling requirement, i.e. legal and functional separation between transmission and distribution vs. upstream and downstream companies. This involves existence of separate legal entities, separation of executive management, maintenance and separate accounts.\textsuperscript{35}

In an effort to fulfill the commitments, Ukraine in 2015 enacted a new law on the natural gas market. The Act of Ukraine of 9 April 2015 on the natural gas market set up the functioning of the wholesale
market: defined the main concepts such as wholesale buyer and seller and established the regulatory body, the National Commission for State Regulation in the field on Energy and Municipal Services. The 2015 law has given priority to security of supply of natural gas underscoring the need to diversify supply. It has also introduced principles of free trade in natural gas and equal treatment given to all trading entities (independent of their country of origin) as well as unrestricted choice of natural gas supplies and freedom from state interference in the natural gas market. The law also provided two options for unbundling of the gas transmission system (GTS): ownership (OU) vs. independent system operator (ISO) option.36

In 2016, Ukraine adopted the Act of Ukraine by the National Commission for State Regulation in the Field of Energy and Municipal Services. This has been a significant departure from the previous practice where scope of activity, competences and structure of regulatory body in natural gas sector were dispersed among several legal acts. Even more importantly, in 2016 the Ukrainian government developed a plan to unbundle the GTS by separating an independent operation transportation and storage systems from Naftogaz Group, the vertically structured state company that has been in charge of the system.37 The plan has been implemented gradually through 2019. On September 18, 2019 the Ukrainian cabinet adopted a resolution to follow the ISO model for unbundling of the gas-transmission network (GTS) taking important step toward liberalization of the Ukrainian natural gas market (On Unbundling of Natural Gas Transmission Activity and Ensuring Operation of Gas Transmission System Operator No. 840). In February 2019, the new independent company - Gas TSO of Ukraine LLC- was established to take over as an operator independent from Naftogaz Group on January 1, 2020.38

The push for unbundling has not been yet successful when it comes to gas storage facilities that have remained part of Naftogaz. Until 2019, over 98 percent of the natural gas transactions took place on the OTC (over-the-counter) market, when Naftogaz (via Naftogaz Trading) began participating on the Ukrainian Energy Exchange. The exchange was created in 2010, with first natural gas sale transactions in 2017. The amount of the transactions within the Exchange remains limited, however, due to inadequacies within the Ukrainian natural gas market, including inefficient daily balancing system, limitations on real time procurement of gas by the TSO, lack of derivatives market or REMIT reporting standards for OTC trading. 39

Opportunities and Challenges for Ukraine’s Natural Gas Sector: Analysis

The new Ukrainian government has been focused strongly on ensuring Ukraine’s energy security as it battles with the remnants of the country’s heavy dependence on Russian gas in the past. Abundant, cheap, and often provided without the need of immediate payment, Russian gas supplies became a significant burden and source of economic distress when Ukraine began to seek greater independence from Russian control. Conflict with Russia escalated post-2014, after the latter invaded Ukraine and annexed the Crimea. As a result, Ukraine does not buy Russian gas directly. On its end, Russia is looking to replace Ukrainian transit with other routes, such as Nord Stream 2 and Turk Stream.
This affects Ukraine on two counts: 1) market-priced gas bought by backhaul from the EU is more expensive than Russian gas supplies provided before the conflict(s) and 2) Ukraine stands to lose a significant amount of income that it derives from its transit status. While both factors are difficult economically, they also provide a way for the country to establish its independence (particularly from Russian political influence) and, potentially, forge stronger ties with the EU and the US.

Ukraine has made important steps to achieve these goals. It redesigned its natural market in line with the EU principles of free market competition and transparency. The government has pushed strongly for both, developing more domestic natural gas supplies and establishing ties with the neighboring countries to enable Ukraine to import gas from non-Russian sources.

However, much more needs to be done for Ukraine to be successful in achieving its goals.

To begin, the government must stand firm behind implementation of the new law. Unbundling of the natural gas transmission network is an important step but needs to be followed by the unbundling of storage system as well. Natural gas storage can be an important element of Ukraine’s cooperation with the EU. The country used to be the grain storage point to Europe in the past. Now it can provide natural gas storage to the continent improving security of demand (See Figure 6).

**Figure 6. Gas Storage in Ukraine**

Additionally, legal unbundling must be accompanied by actual actions and lack of “behind the scenes” influence and/or any corruptive practices. To this end, the government should focus on restructuring its energy sector, particularly large companies such as Naftogaz that are plagued by
inefficiencies typical to monopolist providers. Updating aging infrastructure is also paramount. In addition, much will depend on regional and local politics and transparency of governments and deal-making at those levels.

Ukraine’s government should focus more on energy efficiency measures, including reexamining its natural gas subsidies to make sure that the subsidies are not mismanaged or ineffective. This also includes supporting updates to communal heating and promoting cleaner, more efficient systems such as individual metering. In addition, as Ukraine builds up its economy, the energy intensive heavy industry should be replaced by less energy intensive, modern industrial production.

However, perhaps the most significant challenges ahead of Ukraine’s natural gas sector go far beyond the energy sector itself. In fact, they are systemic and Ukraine will need time and extraordinary effort to overcome them. These challenges are related to general country governance issues and large element of instability that conflict with Russia introduces. Without transparency and stability, Ukraine will have serious difficulties attracting investment and financing for any projects it wishes to introduce. This concern holds particularly with respect to the energy sector, characterized by the need for large investment or, in case of shale exploration, a steady flow of financing to enable constant drilling.

In a way, the novice president and his newly established party have an important advantage here, a clean slate from which they can try to build a more transparent governance structure. In fact, both president and the party ran on a platform that promised the end of corruption. Now they need to deliver, and that will not be an easy task. As unscathed as the new governing forces have been, they have also been inexperienced and lacked the operative knowledge of their predecessors. Zelensky needs to navigate the waters between engaging the former elite and staying committed to anti-corruption platform. The events of March 2020 show that this is not going to be an easy task. The complete reshuffle of the cabinet marked a significant turn to more experience. Denys Shymhal took over prime ministerial post, which led to speculations of Zelensky’s turn away from pro-reform and anti-corruption platform. The Minister of Internal Affairs, Arsen Avakov who has been retained from the former administration has risen in power given his political experience but has been noted to have connections to Ihor Kolomoisky, a Ukrainian oligarch. The new government has to be very careful here not to follow in the steps of its predecessors who have allowed the oligarchs to take over country governance, including in the natural gas sector. This importantly includes following the rule of law. In this context, the recent dismissal of Ruslan Riaboshapka from the post of Prosecutor general has been disappointing to Ukraine’s Western allies that viewed him as an independent figure. It remains to be seen whether his replacement, Iryna Venediktova continues on this path.

In addition, the government will be challenged by the instability produced by the continuing occupation of Eastern Ukraine by Russia. There is significant amount of uneasiness on the part of the Ukrainian population with the agreement Zelensky’s chief of staff reached on March 11 with Russia to give status of “people’s republics” to Russia-occupied Donbas region. As of the time of writing, the fate of the agreement is still unclear with Zelensky support but many, even from his own Party, strongly against what they believe would legitimize Russian occupation of Eastern Ukraine. Unfortunately, the situation is extremely difficult and will likely take long to resolve. Moreover,
Russia is unlikely to back out from the region if only for the reason that a stable Ukraine would be more likely to integrate with the EU and would be influenced by the EU, the US or other Western parties via investment and presence of international companies. Therefore, one of the most pressing goals for the Ukrainian government is to not only seek resolution of the issue but also support of Western governments for investment in Ukraine that could reduce some of the risk companies take. Once again, here implementation of a transparent and modern legal structure of natural market introduced by the recent reform is a key for any government of any potential ally to incentivize companies to invest in Ukraine by, i.e. extending financing or financing guarantees.

Conclusion

Ukraine has made important steps in modernizing its natural gas sector.45 Those steps have been entrenched in the country’s law but need to be followed up with actual changes in the industry that embrace transparency and rule of law. The new government has a clean slate that, having embraced a message of anti-corruption, it could effectively leverage by enticing foreign allies to assist Ukraine in the transformation and the challenges associated with Russian occupation of its eastern regions. That being said, the government’s political inexperience can become a source of influence of old forces as well and both Ukraine’s administration and its allies need to be doubly cautious not to allow the old habits to resurface. This may prove particularly challenging at lower levels of government, where the influence of the central government is diffused by politics of powerful local party officials and high-level administrators, who often enjoy significant support of local population. In this context, government social policies may become its largest opportunity. Meeting local populations’ basic needs such as medical care, infrastructure, education etc. may generate a high level of support for the central government and make it easier to influence changes in Ukraine’s regions, including ousting corrupt practices. The 5-year transit contract with Russia is set to generate approximately $7bn and Ukraine received almost $3bn from Gazprom in the December transit deal. This money should be spent wisely and strategically. This needs to include modernizing the gas sector and its infrastructure to enable higher production and ability to import from variety of suppliers as well as less obvious social spending to generate popular support and legitimacy for a new government to implement market reform and oust old forces, detrimental to such reform.

Lastly, while the advice would be sound even a month ago, as global spread of the Coronavirus continues, the Ukrainian government will face challenging choices, including how to allocate the resources. The money resulting from transit contract with Russia will help but will not be enough. Also, some of the foreign funds that would be potentially available as investment, inter-governmental loans, or other type of funding from Europe or the US may not be available any more as the latter have to address the negative impact of the pandemic. With respect to the US, the ultra-low prices of oil are likely to batter the energy industry and devoid it from foreign investment funds. Ukraine has already been looking for help from the IMF but the latter is likely to be overrun with similar requests from all over the globe.46 It helps that Ukraine has been moving closer to assuring board approval for $8 billion loan from IMF as the country parliament pass a law, which will remove the ban on sale of farmland and revised the budget to adopt to challenges associated with the ongoing pandemic. If awarded, IMF funds will likely be tied to good governance and transparency, another reason to put a lot of focus on anti-corruption practices and policies.
### Appendix 1

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<td>3,358</td>
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<td>Average currency rate (USD/UAH)</td>
<td>5.4</td>
<td>7.8</td>
<td>7.9</td>
<td>8.0</td>
<td>8.0</td>
<td>8.0</td>
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<tr>
<td>% of gas transit fee to National Budget</td>
<td>6.0%</td>
<td>7.8%</td>
<td>11.1%</td>
<td>9.5%</td>
<td>7.5%</td>
<td>7.8%</td>
</tr>
<tr>
<td>% of gas transit fee to GDP</td>
<td>1.4%</td>
<td>1.8%</td>
<td>2.5%</td>
<td>2.3%</td>
<td>1.8%</td>
<td>1.8%</td>
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</tbody>
</table>

<table>
<thead>
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<tbody>
<tr>
<td>Fee received for gas transmission service (mln USD)</td>
<td>2,208</td>
<td>2,258</td>
<td>2,631</td>
<td>2,998</td>
<td>2,959</td>
<td>5,904</td>
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<tr>
<td>National State Budget (mln UAH)</td>
<td>357,084</td>
<td>534,695</td>
<td>616,275</td>
<td>793,265</td>
<td>928,108</td>
<td>998,279</td>
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<tr>
<td>National State Budget (mln USD)</td>
<td>30,033</td>
<td>24,464</td>
<td>24,117</td>
<td>29,803</td>
<td>34,116</td>
<td>37,654</td>
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<tr>
<td>Ukrainian GDP (bln USD)</td>
<td>131,805</td>
<td>90,615</td>
<td>93,270</td>
<td>112,154</td>
<td>130,832</td>
<td>149,914</td>
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<tr>
<td>Average currency rate (USD/UAH)</td>
<td>11.9</td>
<td>21.9</td>
<td>25.6</td>
<td>26.6</td>
<td>27.2</td>
<td>26.5</td>
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<tr>
<td>% of gas transit fee to National Budget</td>
<td>7.4%</td>
<td>9.2%</td>
<td>10.9%</td>
<td>10.1%</td>
<td>8.7%</td>
<td>15.7%</td>
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<tr>
<td>% of gas transit fee to GDP</td>
<td>1.7%</td>
<td>2.5%</td>
<td>2.8%</td>
<td>2.7%</td>
<td>2.3%</td>
<td>3.9%</td>
</tr>
</tbody>
</table>
What’s Next for Natural Gas in Ukraine?

AUTHORS

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Reference List


Figure 4. Gas Transmission Fees vs. Ukraine’s Budget & GDP (in million USD)
Endnotes


3 The apparent increase to 48 percent in 2019 has been related to Ukraine preparing for the possibility of Russia not renewing the transit agreement rather than systemic change to the downward trend in imports.


8 The large jump in fees share in 2019 is an aberration as it resulted from one-time payment by Gazprom reflecting the results of Stockholm Arbitration in 2017. See detailed information on fees amounts in USD & UA in Appendix 1.


