March, 2017

Newsletter

Ukraine Gas Market

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Foreword

Stober, Poltavets & Associates will begin to provide an ongoing coverage of the Ukrainian gas market. We are doing this for a number of reasons:

First, there are plenty of untold stories about this process – stories that are never heard outside the small expert community. Reforms have been pushed out of the news agenda, as other, and more negative, developments, have dominated Ukraine business headlines for the past two years.

Second, the progress and the changed market dynamics in Ukraine's gas trade are probably the best examples of how the country has turned towards the west. From being more or less 100% dependent on Russian gas imports to satisfy industrial and private consumption, its total imports are now from European partners. Moreover, international financial institutions have been deeply involved in shaping up the market environment, and there are many parallel conversations going on, which will ultimately have an important impact on the opportunities to do business in the Ukrainian gas sector. We believe it is important to have a central place from which to follow this process.

Finally, then there is the question of privatisation and governance. Naftogaz – the local gas behemoth – is facing increasing pressure to reform its corporate governance structure, and privatisation in the sector is on the agenda. With this entire process going on we think that foreign observers, investors, and business partners, would do well to monitor developments closely. We are happy to schedule calls to clients, to discuss specific matters.

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February takeaways: Gas reform on the march but question remains

On 14 February, Naftogaz's commercial director, Yuriy Vitrenko, went to the press arguing that the painful reforms conducted in his company over the past 2 years have transformed Ukraine's gas market, and now, for the first time in its history, Ukraine has a properly functioning market, rather than a political insider's game. Vitrenko also said that Naftogaz's share of the market for commercial domestic consumers is no more than 34%, compared with the strong monopolist situation of a few years ago.

At the same time, Ukraine is importing approximately 1/3 of its total annual gas from primarily Western firms, which, until two years ago were not in the market. It is therefore true to say that there has been a dramatic change in the local marketplace, but it is unclear whether the merits of Vitrenko's reforms have changed the game, or whether it is merely a consequence of *realpolitik*.

What is true is that Naftogaz has, in a massive way, reduced its position as a sole trader; today other companies also supply gas to commercial consumers (mostly in industry). It is also expected that further liberalisations will include private consumers, who should have a real opportunity to choose from different suppliers.

Once this happens, consumers should benefit from lower prices and better service, and society should also be better off – or so the theory goes – and the market should finally work as it should. It will also mean that Gazprom's monopoly on export to Ukraine will finally have been broken and the once-so-mighty Naftogaz will be just one of many suppliers. There are, however, other major hurdles that might have an impact on, and ultimately change, the course of events.

One of these is the Stockholm arbitration court decision on the case between Naftogaz and Gazprom: a ruling is expected later this year. The case, which dates back to 2014, is about the interpretation of transit fees and gas import prices – contracts that were signed and agreed upon, by previous governments, and in a very different political context. The two parties' positions are very far apart, and the Court decision is likely to affect Ukraine's gas market in a substantial way. In the event of a positive ruling for Naftogaz, local experts say that it could reduce overall prices by some 40%, which would not only be a major boost for consumers, but would also significantly improve Naftogaz's balance sheet. Should the court verdict go against Naftogaz, prices would rise dramatically, and experts are not sure about the sustainability of the company.

Another thing to look out for is a new draft law (#3325 from 10.15.2015), which will require regional gas companies to rent out regional pipelines. This will almost certainly push consumer prices higher, as regional companies seek to be compensated for greater expenses. How the recent extradition decision by the Viennese Court, regarding Ukraine's leading gas oligarch, Dmytro Firtash, will affect local markets, is still too early to tell. It is likely, however, that his dominant position will be challenged, in one way or another.

All of this might not matter too much to foreign companies looking to sell into Ukraine. For those firms, pricing strategy is the crucial element, and today there seems to be a very important cost advantage in selling from European gas hubs. European gas imports are connected to the spot market, and are therefore much more flexible than securing political deals with Gazprom. For example, a wise pricing strategy for Ukraine gas importers would be to fill up storage when the European summer period starts, and when spot contracts are substantially lower than those of Russian competitors (notwithstanding the political element of sourcing directly from Gazprom).

Finally, Ukraine opened its gas market for European gas traders in 2015-2016, and since then the share of European gas imports is growing, not only as a percentage of the total market, but also in terms of the number of European firms seeking to do business in Ukraine. Considering the geopolitical reality, and with no easing-up of bilateral Russian-Ukrainian relations in sight, it looks as though 2017 will also be a good year for European gas traders doing business in Ukraine.

[1] nv

[2] rada

Government plans to avoid gas import after 2020

Friday, 17 February 2017.

Prime Minister Volodymyr Groisman has announced the government's plan to increase the internal production of gas, to cover all Ukraine's requirements for business and private households, until 2020. The level of import in 2016 was 8.2 billion cubic meters of gas, covered by 15 European companies (Engie, RWE Supply and Trading, Uniper Global Commodities, TrailStone, Shell Energy Europe, Axpo Trading, Statoil, PGNiG, CEZ, and others). The government's plan is too optimistic; in reality the best chance is to have gas imported from Europe to Ukraine.

UKRINFORM

Naftogaz: no negotiations with Gazprom

Thursday, 16 February 2017.

Commercial director of Naftogaz, Yuriy Vitrenko, has claimed that Ukrainian company is not in negotiations with Gazprom on the issue of renewing gas supplies to Ukraine. Gas import from Europe fully covers Ukraine's requirements, so there is no need to buy Russian gas. Naftogaz policy is to wait until the decision of the Stockholm arbitrary court, in autumn 2017, regarding the contract with Gazprom, and only then will it plan further relations with the Russian side.

1PRIME

IMF agrees with Ukraine on new conditions for gas pricing

Friday, 17 February 2017.

The Ukrainian government and the IMF have agreed on a new procedure for changing the gas prices for the population of the country after 1 April 2017. Gas prices will be revised each half year, using as a base the average imported gas price for the previous 6 months. This will allow the government to protect the population from spikes in gas prices.

UKRANEWS

News in brief

Russia cannot stop reverse gas to Ukraine

Thursday, 16 February 2017.

Russia's energy minister, Alexander Novak, has proved that his country had no legal right to stop the reverse flow of Russian gas from Europe to Ukraine. Novak claims that the main gas export to Ukraine via Slovakia is done with Russian gas, which can be proved by the balance of Russia's gas supplies to Europe. However, Russia admits the right of Ukraine to buy gas from Europe, according to EU legislation, if Ukraine should choose such an option.

UKRANEWS

Enterprises' gas debts to Naftogaz are growing

Wednesday, 15 February 2017.

The gas debts of Ukrainian industry before Naftogaz are growing and now total 34.1 billion UAH (about 1.2 billion euro), which will complicate the process of reform inside the company. About 80% of the debt is for gas consumed for heat production so, for private gas suppliers, selling gas to heat-producing companies is not the best option. There is also a political element, in that the biggest debts to the state company, Naftogaz, are those of heat-generating companies of formerly the biggest Ukrainian oligarch Rinat Akhmetov.

NAFTOGAZ

Ukraine has enough gas in underground storages

Wednesday, 15 February 2017.

Naftogaz has released information that there are currently 8.9 billion cubic meters of gas in underground storages; this will allow all consumers to get through this heating season successfully. The necessary minimum of 6 billion cubic meters in storages allows Naftogaz to use about 2.9 from the current total of 8.9, which is enough to meet the needs of Ukrainian consumers, both in the general population and business, who are getting used to paying fair market prices for gas. It will be hard for Gazprom, or any other gas players, to play on the issue of panic about low levels of gas storage, and to push Naftogaz to buy additional amounts of gas in March 2017.

FACEBOOK_NAFTOGAZ

News in brief

Poland still the popular route for gas export to Ukraine

Friday, 10 February 2017.

In 2016, Polish company PGNiG signed an agreement with Ukrainian company, ERU Trading, which will allow it to sell 400 million cubic meters of gas to Ukraine. Top-management of PGNiG is interested in the Ukrainian gas market, and plans to expand their gas exports in this direction, to up to 1.5 billion cubic meters, which is the maximum technological capacity of the gas route from Poland to Ukraine today.

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News in brief

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CALENDAR

From **1 March,** Naftogaz will lower gas prices for industrial consumers by 7%.

Up to **13 March,** Ukraine's gas market regulator will accept proposals for changes to the Code on gas storages, which will allow more effective use of gas storing capacities.

By **17 March,** the emergency regime in Ukraine's energy system, implemented by the government's decision, is to be reviewed by the Government.

On **24 March,** the internal audit of Ukrtransgaz (which manages the main gas pipelines in Ukraine) will be finished; this might lead to changes in the management of the companies, under Naftogaz

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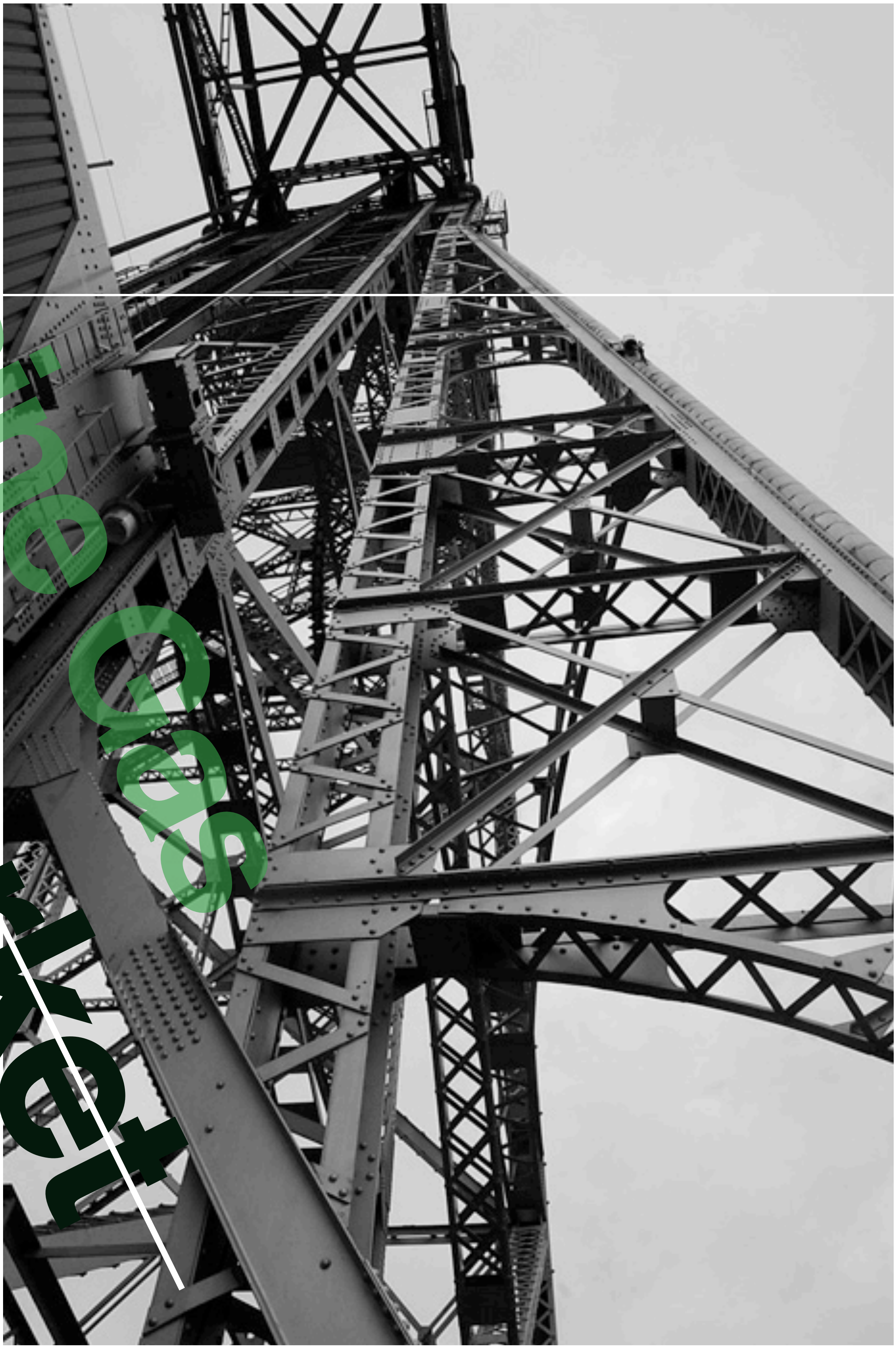
For more information about these stories, or to get in touch with an analyst, please contact info@stober-poltavets.com



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