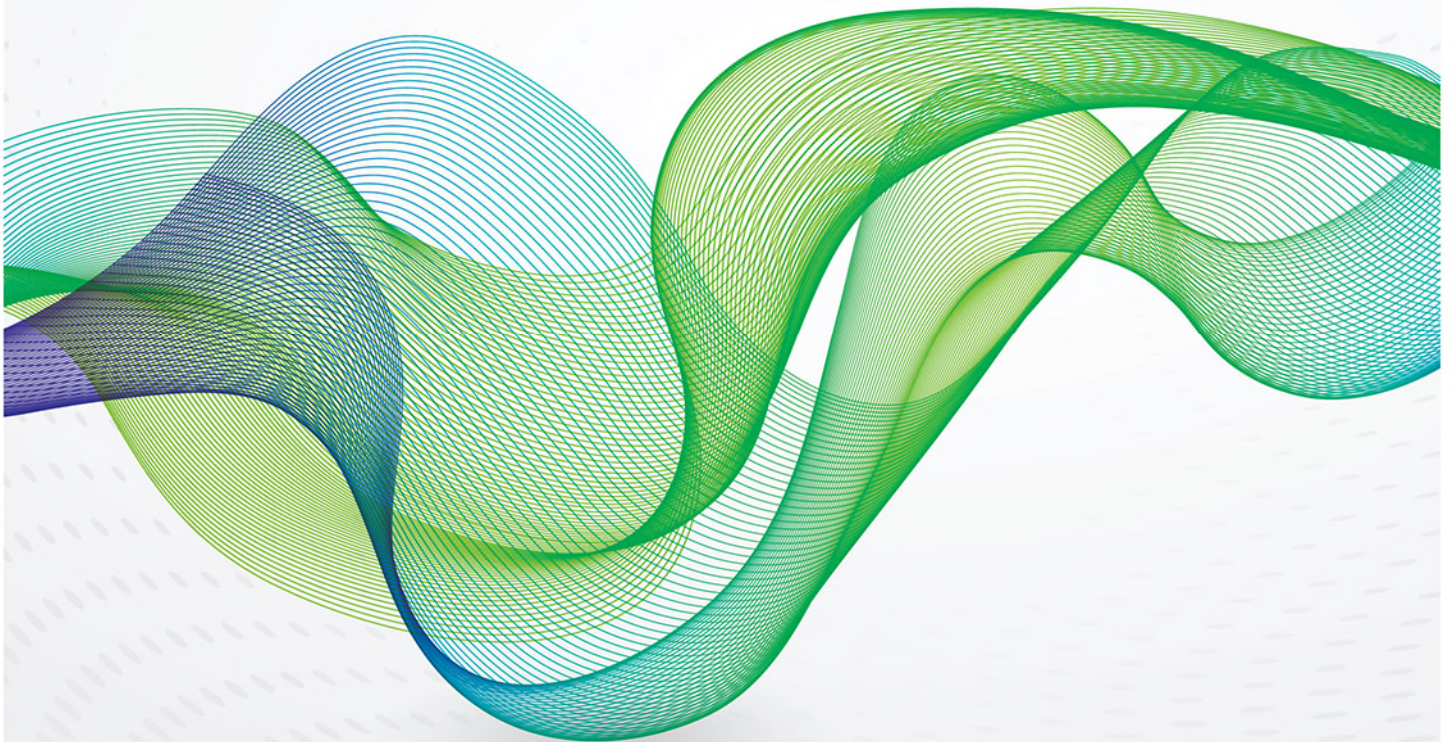
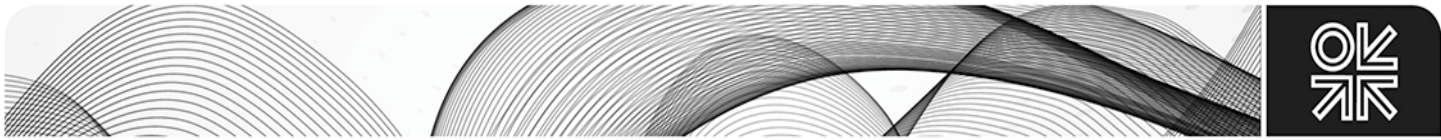


November 2016

# Has Ukraine scored an own-goal with its transit fee proposal?





## ***Gazprom's long term strategy to get rid of Ukraine transit risk is progressing fast. Ukraine has few options left.***

Last month, Naftogaz potentially lost \$700m/year from the \$1.7bn<sup>1</sup> transit revenue it received in 2015 from Gazprom for transiting 64.1 bcm. With the intergovernmental agreement signed on 12 October 2016 between Russia and Turkey, the 17 bcm/y currently transiting Ukraine for Turkey could well disappear from 2020. Furthermore, following the recent EU Commission deal on OPAL, an additional 10 bcm/y bound for Europe could disappear even sooner<sup>2</sup>, giving rise to the possibility that transit volumes through Ukraine could be as low as 37 bcm/y post 2020. On 10 November this year, the Polish gas monopoly PGNiG asked<sup>3</sup> that the European Commission publish the text of its decision on OPAL. However, until the European Commission has done so, the state-owned company cannot take any legal steps against it, and, as a result the rerouting of gas via Nord Stream 1<sup>4</sup> will increase its load factor and profitability,<sup>5</sup> and could also improve the business case for Nord Stream 2<sup>6</sup>.

The OPAL decision also raises the question of continued EU support for Ukraine, even as the latter continues to fight both militarily and politically with Russia. On the political level, it would seem that Ukraine has lost some support in Europe. It must now at least be an open question as to whether the European Commission will feel able to continue its support of Ukraine, at a time when European citizens have other priorities<sup>7</sup> (employment, migration) and European companies continue to prefer to deal with Russia, as it is the largest oil and gas resource holder in the world and the largest seller of hydrocarbons to Europe. Brussels also has other priorities, not least of which is the need to solve the current Brexit issues. In addition, EU sanctions in response to Russia's actions in the east of Ukraine and Crimea, introduced on 31 July 2014 and prolonged until 31 January 2017, could be more difficult to renew in future, as evidenced by the Italian prime minister preventing the European Council from publishing a call for sanctions against Russia on 20-21 October 2016. The recent election of Donald Trump in the US also gives rise to uncertainty for Ukraine going forward.

<sup>1</sup> From Naftogaz 2015 Annual Report and 27 October Press Release (<http://www.naftogaz.com/www/3/nakweben.nsf/0/8EC8CCE01CF6AA19C22580590037943D?OpenDocument&year=2016&month=10&nt=News&>), we have assumed a \$29m/bcm for 47 bcm transit price for EU and \$16m/bcm for transit price for Turkey (17 bcm) and Moldova (3 bcm).

<sup>2</sup> 28 October press release [http://europa.eu/rapid/press-release\\_IP-16-3562\\_en.htm](http://europa.eu/rapid/press-release_IP-16-3562_en.htm). The decision is expected to be published in a few weeks on <https://ec.europa.eu/energy/en/topics/markets-and-consumers/wholesale-market/access-infrastructure-and-exemptions> once any questions on potential confidentiality have been resolved, as the decision may contain business secrets. It will then be examined by OPAL before being translated in more gas shipped via this pipe <https://www.opal-gastransport.de/en/press/press-releases/press-release/news/opal-gastransport-qmbh-co-kg-examines-decision-by-the-european-commission/>

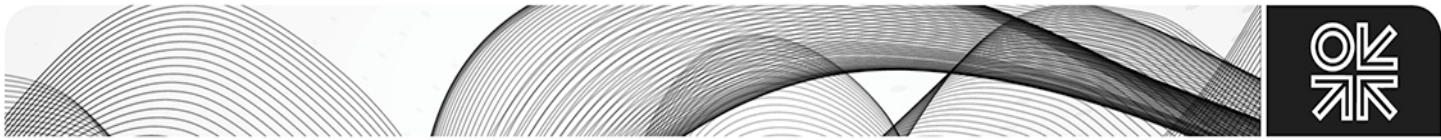
<sup>3</sup> <http://en.pgnig.pl/news/-/news-list/id/pgnig-increased-gazprom-access-to-opal-gas-pipeline-is-extremely-disadvantageous-to-all-cee-countries/newsGroupId/18252>

<sup>4</sup> The 2 outgoing pipes from Nord Stream 1 are NEL (with a capacity of 62 mcm/d) and OPAL (with 55 mcm/d allowed out of the 97 mcm/d total capacity). This means that Nord Stream 1 was limited to 117 mcm/d out of a total 151 mcm/d or 77% on an annual level. With this new deal, c. 90% of Nord Stream 1 could be used, which makes it as if fully used (as there is always annual maintenance to do).

<sup>5</sup> In 2012, for a full load factor, the cost of using Nord Stream 1 was estimated at \$39m/bcm with then high fuel cost ("After the US shale gas revolution" – Thierry Bros). We can estimate that with lower gas prices, the cost of using Nord Stream 1 is around \$37m/bcm.

<sup>6</sup> Nord Stream 2 (like South Stream) is a transport infrastructure that will have to meet stringent EU regulations. Any request of Third Party Access as soon as an offshore pipe enters European waters de facto kills the project (technically and economically). Potential solutions from the EU side could be for Nord Stream 2: selling gas in Russia or allowing any Russian independent gas producer to use part of the pipe. Both options are fiercely opposed by Gazprom. Alternatively, if neither the EU nor the Russian regulations can apply to a single piece of infrastructure, then the last solution is to go back to an intergovernmental agreement dedicated for Nord Stream 2. Gazprom could also issue convertible bonds (bought by its European partners) to finance this infrastructure.

<sup>7</sup> The Dutch Ukraine–European Union Association Agreement referendum was held in the Netherlands on 6 April 2016. 61% of votes were against showing that the Dutch people are against establishing closer ties with Ukraine.



### **Economic competition matters**

In light of all these issues the transit of Russian gas through Ukraine stands out as an extra political and commercial stumbling block. Ukraine has been the main route for transiting Russian gas to Western Europe since the Soviet era. However, even in the 1990s Gazprom and the Russian state found this less than ideal. Alternative routes were therefore built by Gazprom to supply a growing European gas market, including Yamal-Europe (33 bcm/y) in 1994, Blue Stream (16 bcm/y) in 2004, Nord Stream 1 (55 bcm/y) in 2011 and Beltransgaz (5 bcm/y)<sup>8</sup> in 2012. However, EU gas demand has fallen since the financial crisis in 2008, and as a consequence there is already competition between those routes and Ukrainian transit. In addition, all the pipelines compete with European regas terminals that are currently operating with a low load factor. As a result transit through Ukraine and resulting revenue has fallen, and may fall further, begging the question “what is best for Ukraine now?”

One plausible answer is that Ukraine would be well advised to grasp the fact that economics matters in a level and competitive playing field in the energy sector. In order to maintain the remaining flow (of both revenues and profits) of Russian gas transiting to Europe, Ukraine should therefore shift its transit negotiation strategy away from policy and towards commercial reality. In other words it needs to adapt its negotiating strategy rather than labelling Nord Stream 2 as “a Trojan horse for Europe”<sup>9</sup>. As new pipelines are opened in a world where European gas demand is declining, the logic of natural infrastructure monopolies has changed to an era of competition between routes. Naftogaz could make Nord Stream 2 financially less attractive by reducing the price of its own transit. By offering a cheaper Ukrainian transit agreement for the period 2020-2030<sup>10</sup>, Gazprom’s European partners (Engie, OMV, Shell, Wintershall and Uniper) would have more difficulty justifying the €8bn investment in Nord Stream 2 to their shareholders and to the EU Commission. But Naftogaz is instead suggesting<sup>11</sup> that it wants to greatly increase its transit prices from 1 January 2016, *de facto* making the position of Gazprom and its European partners stronger with respect to Nord Stream 2.

Naftogaz’ argument is based on the fact that it significantly revalued its transmission assets in 2014 by a factor of 4 in local currency (or from \$7.7bn to \$15.2bn). This effectively led to a significant decline in the ratio of return on assets in this segment of its business. Naftogaz therefore declared in its 2014 annual report that:

“...this indicates that the transmission fee under the contract with Gazprom is lower than economically justified levels and [the company plans] to shift to a Regulated Asset Base (RAB) methodology from 4Q 2015, in order to ensure a fair return on assets”<sup>12</sup>.

However, this statement raises a number of anomalies. Firstly it is strange that Naftogaz defines its transmission segment as a “non-regulated business” but then wants to apply a Regulated Asset Base methodology to it. Secondly, the assets, which were built under the Soviet regime, are getting older and oversized in a world where gas demand in Europe is declining. As a result, the argument for any increase in their value<sup>13</sup> appears to lack credibility. If anything, these transmission assets, which were used for transiting more than 100 bcm/y prior to the construction of Nord Stream 1, should now have a reduced not increased<sup>14</sup> value.

<sup>8</sup> This is the capacity of the system to Poland. The capacity to Lithuania is 10 bcm/y, but this is not in competition with the other lines to Western Europe.

<sup>9</sup> Naftogaz 2015 Annual Report p34.

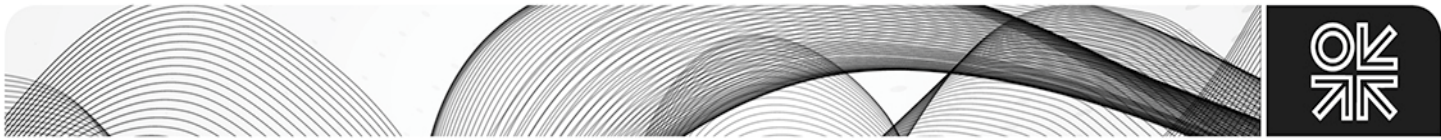
<sup>10</sup> The actual contract ends on 31 December 2019.

<sup>11</sup> Gazprom is unlikely to agree to this as the estimated cost of the alternative option, Nord Stream 1, is around \$2.9/1,000cm/100km. And the ship-or-pay clause cannot as suggested by Naftogaz be for capacity above 50 bcm/y as the 17 bcm/y for Turkey should already be taken away after the agreement to build TurkStream.

<sup>12</sup> p134.

<sup>13</sup> P137.

<sup>14</sup> This is even a major issue for the European Commission who is looking on how to design better gas markets post 2020 in a world where stranded infrastructure should not impede EU welfare state.



Nevertheless, in line with its somewhat strange reasoning, Naftogaz has been trying, since 1 January 2016, to implement new entry and exit tariffs for transit via Ukraine introduced by the state regulator. The tariffs<sup>15</sup> for all entry points to the gas transmission system of Ukraine are at the same level of \$12.47m/bcm while there are different tariffs for various exit points ranging from \$16.74m/bcm to \$32.80m/bcm. The consequence is that if the current non-regulated contract between Gazprom and Naftogaz is converted into a regulated contract for capacity booking of 110 bcm/y through to 2019, the price will move from \$27m/bcm on a flow basis to \$45m/bcm on a capacity basis.<sup>16</sup> Naftogaz argues that this would then allow it to charge a reduced fee post 2020 as the transit assets would then be fully depreciated post 2019. Furthermore, Naftogaz's idea is:

- to bring the contract in line with EU regulation on transportation;
- to increase revenues even if flow decreases<sup>17</sup>;
- to be able to show lower transport fees from 2020.

The mechanics of implementing any change to the transit methodology are complex, though. Since 2010 the tariff for gas transit through Ukraine has been calculated based on the price formula set out in the 2009 transit contract<sup>18</sup>. However, following recent amendments made to Ukrainian legislation, the National Commission of Ukraine is now responsible for setting tariffs for gas transportation services via cross-border pipelines. And, accordingly, Naftogaz should now attempt to implement this new legislation, indeed under the 2009 contract Naftogaz is allowed to "claim to review the rates of payments for the price of transit". However, if agreement is not reached within three months, each party of the 2009 transit contract has the right to lodge an arbitration.

Naftogaz's position does carry significant risks though, and is likely to generate a strong commercial and legal challenge from Gazprom. There are a number of solid reasons for this, including:

- The new tariff rate for transit of Russian gas through Ukraine cannot be introduced without amending the existing contract, but Gazprom is unlikely to accept any change to the 2009 contract as arbitration is currently pending regarding the 2009 gas supply contract and Naftogaz's debt owed for supplies in 2013 and 2014<sup>19</sup>;
- The 2009 contract is a contract between Naftogaz and Gazprom and does not mention the regulator. As a result Gazprom is unlikely to accept any changes based on the rulings of the new Ukrainian regulator;
- This change in contract should be settled by an arbitration tribunal,<sup>20</sup> but Naftogaz has little chance of being successful there<sup>21</sup>;

<sup>15</sup> Naftogaz 2015 Annual Report – p195.

<sup>16</sup> The \$29m/bcm comes from Naftogaz 27 October Press Release while the \$45m/bcm assuming the gas for EU flows at the most expensive exit.

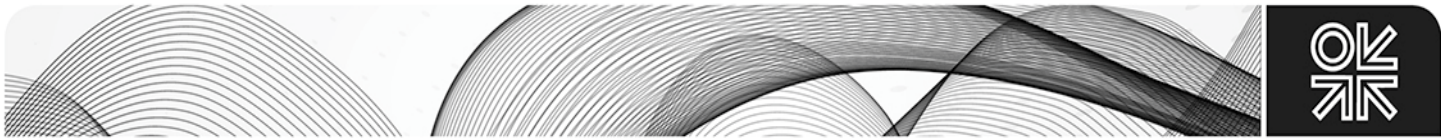
<sup>17</sup> Under the actual contract, if Gazprom reduces its flow via Ukraine (and this could happen following the 28 October decision of the EU Commission), Gazprom could reduce its Ukrainian transit fee but not under the new Ukrainian proposal.

<sup>18</sup> According to the leaked version published then by the press, the price of transit in 2010 was set at 1.9\$/1000cm/100km (excluding the fuel cost that was calculated as reference to the supply contract) with an assumption of 1,240km for the transit distance in Ukraine (or \$23m/bcm).

<sup>19</sup> Naftogaz is seeking retroactive price revision under the 2009 gas supply contract between Gazprom and Naftogaz. In addition, Naftogaz is seeking compensation for all amounts allegedly overpaid from May 2011 to October 2015, which, according to Naftogaz's current assessments, amounts to \$14.23bn, and cancellation of the contractual prohibition on re-export of gas. Between 2012 and 2015, Naftogaz failed to off-take the contracted-for volumes of gas as provided by the 2009 contract. Pursuant to the "take-or-pay" clause set forth in the 2009 contract, Gazprom issued invoices to Naftogaz for \$7.09bn, \$11.39bn, \$8.20bn and \$2.55bn for the failure to purchase corresponding volumes of gas in 2012, 2013, 2014 and 2015, respectively. Naftogaz has neither accepted nor paid those invoices.

<sup>20</sup> Hearings in December 2016.

<sup>21</sup> The RAB methodology proposed by Ukraine is not the only way of calculated revenues for old assets in Europe and, if used, it must take into account the amortisation of this old network.



- Gazprom is very unlikely to ever use the full 110 bcm/y of the Ukrainian transit system.<sup>22</sup> If one assumes that Gazprom only uses 47 bcm/y for transit to Europe, as witnessed in 2015, the implicit tariff on a volume basis rises to \$106m/bcm (compared to \$45m/bcm if the full capacity is used). While this would increase revenues to Ukraine from \$1.3bn to \$5.0bn per annum, it would make the implied tariff very uncompetitive with Nord Stream 1 (\$37m/bcm) and would make the case for constructing Nord Stream 2 much stronger.
- In complete contrast, Gazprom obviously wants to benefit from a lower overall fee if it uses the Ukrainian transport system less; the 2009 contract is a volumetric one and therefore it would expect lower transit volumes to imply a lower cost;
- Confusingly, though, in its recent communications, Naftogaz has used both formulae<sup>23</sup> at various points, making it unclear what its exact plan is;
- Furthermore, given the fact that the profit margin in its transit business is 45%,<sup>24</sup> while the average operating margin in its overall business is only 6%, with a loss of \$1.5bn having been reported in 2015, it would be logical to ask, on reading Naftogaz's accounts, whether it is using its dominant position as a transit country to cross-subsidise the rest of its business, to the detriment of both Russia and Europe.

Lowering the current transit fee could therefore be a sensible move,<sup>25</sup> particularly as Naftogaz is already considering this strategy post 2020, and it should also be accompanied by improved margins in its other activities. In contrast by hiking the tariff now, Ukraine is sending the opposite message to stakeholders, who have no reason to assume that Naftogaz will fulfil its pledge to reduce prices later, especially as by then it may be purchasing no gas from Russia and will therefore have a much stronger bargaining position than in the past, when it was reliant on imports from Gazprom. The latter might well therefore assume that it would be better off with an alternative transit option (Nord Stream 2). In short, Ukraine could be seen as providing the green light for the construction of Nord Stream 2 by increasing its own transit tariff.

In conclusion we would argue that in Europe Gazprom has started to vary its marketing strategy by using a variety of methodologies, including selling gas via the traditional long term contracts, via auctions, via Gazprom Marketing & Trading and via Wingas (its 100% owned European utility). As a result it has gained flexibility (that was formerly in the hands of the European utilities) and can adapt much faster to market changes. It would now seem that Naftogaz may also be forced to adapt to new realities and to react to competitive pressure by reviewing its transit fee strategy, potentially even reducing its transit fees. Indeed, given there appears to be no realistic chance left for increased transit revenue, Ukraine's choices appear limited if it wants to retain part of the \$1bn/y transit fee<sup>26</sup> that does remain.

<sup>22</sup> In its 2016 forecast, Naftogaz uses 70 bcm for expected volume from Gazprom contract (including gas for Turkey).

<sup>23</sup> The 27 October Press Release uses the 2009 contract formula to do the maths. In the 2015 Annual Report, Naftogaz mentions for 2016 the new formula (p24) and for its forecasts (p193-195).

<sup>24</sup> \$0.9bn profits in 2015.

<sup>25</sup> Naftogaz claims that the assets would then be fully amortised in 2019 but it can also be claimed that the asset paid under the soviet regime have already been completely paid for thanks to the past 30 years+ of transit.

<sup>26</sup> Estimated from the \$1.7bn received in 2015 minus the \$700m at risk after the TurkStream and OPAL decisions.