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UKRAINE 2019 ELECTIONS: WHAT NEXT FOR GAS MARKET REFORM?

By Aura Sabadus

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BY AURA SABADUS MARCH 2019

A chocolate king, a gas princess and a TV comedian are the front-runners in a long list of 44 candidates vying for votes in Ukraine's first round of presidential elections scheduled for 31 March.

The political arena is awash with promises, accusations and backstage manoeuvring.

But beyond the noise, there is no doubt that the outcome of the impending polls and of the parliamentary elections in October will have global significance as the country has been at the heart of an ongoing confrontation between the West and Russia for the last five years.

Since the Euro-Maidan revolution of February 2014 when a series of violent protests led to the ousting of the then Russian-backed president Viktor Yanukovich and the overthrow of the government, Ukraine embarked on wide-ranging reforms.

It sought to improve public administration and bring decentralisation to its provinces. It introduced banking reform to consolidate the financial sector. It pushed for greater transparency as a means to crack down on endemic corruption.

In energy, and, most importantly, in the gas sector, which had been the biggest drain on the state budget, it took steps to liberalise the market, seeking to unify gas prices to plug a yawning subsidies gap that absorbed 8% of the country's annual GDP, improve the governance of the gas incumbent Naftogaz and implement EU rules.

Yet progress has been slow. The economy has been growing at an annual 2.5% rate since 2016; corruption remains rife and the liberalisation of the natural gas sector has not been as swift as some observers may have hoped.

In short, Ukraine remains "a work in progress", as Peter Dickinson, non-resident fellow of the Atlantic Council, a US-based think tank, told ICIS in a recent interview.

Radical changes may be hard to enforce in a country which struggles to remove an entrenched kleptocratic elite and has been through multiple traumatic experiences such as the loss of Crimea in 2014, an ongoing simmering war with Russia in the East, which has claimed no fewer than 11,000 lives and a 10% economic decline in 2015.

But reform is a must because, given Ukraine's importance



as Europe's largest country by size, its geographical position as a buffer between the East and the West and its significance as a major gas transit route to Europe and Turkey, any political or economic relapse could have a spillover effect regionally.

In this context, overhauling the gas sector is critical, not only because historically it has been one of the biggest sources of corruption, but also because Ukraine, as the key transit route of Russian supplies to Europe, may have to rethink its role within the European gas dynamics, as exports look set to be diverted to Nord Stream2, a Moscow-backed pipeline, from 2020.

As the country starts its electoral cycle this month and a new president and administration are voted in, the question that emerges is whether the incoming incumbents would pursue and fast-track reform or, given a tide of populism sweeping the world, would seek to reverse it to the days before the Maidan revolution.

This paper proposes to examine the political manifestoes of the top presidential candidates and to assess to what extent their objectives would tally with Ukraine's three key gas reform goals, namely the elimination of subsidies, the consolidation of independent state entities and the definition of a new role in Europe's energy supply dynamics.

CHALLENGES

For most of the post-Soviet independence years, Ukraine's gas sector sat squarely at the heart of political cronyism, involving corrupt practices that enriched politicians as well as financial and industrial groups in Ukraine and Russia.

Billions of dollars were embezzled either through intermediary schemes involving Russian and Ukrainian companies or business people, production sharing agreements (PSAs), public obligations to sell locally produced gas to households below market prices or opaque supply contracts with Russia which often entailed political concessions granted by Kiev.

These practices were possible on two accounts.

Firstly, Ukraine had a system of subsidies in place, which was in theory supposed to help an impoverished population to pay their gas bills, but in practice proved to be the biggest source of economic rents, amounting in some years to as much as 5% of the GDP or €4bn per year, according to a study by the Institute of Economic research and Policy Consulting, a Ukraine-based think tank.

Secondly, as the same study points out, the operation of the gas market was a classic example of political corruption, where government authorities representing political forces competed for the right to appoint the management of the Ukrainian gas incumbent Naftogaz and through it to control the financial flows required for the enrichment of politicians and business people.

Ukraine's vulnerabilities allowed intermediary schemes such as RosUkrEnergo (RUE) to thrive. The company was set up in 2004 based on an agreement between Russia's Gazprom and Ukraine's Naftogaz and soon became the monopoly supplier of gas, initially sourced in Turkmenistan and then in Russia after 2006.

Up to 50 billion cubic metres (bcm) of gas were sold annually to Ukraine at prices that rose from \$95.00/ thousand cubic metres (kcm) to \$180.00/kcm, while the

production price in the countries of origin was thought to be much cheaper.

There is no official data regarding the production costs for Turkmen or Russian gas at the time, but the same think tank estimates that the difference between the production costs and the price of gas sold in Ukraine caused it to lose \$38.6bn throughout the duration of an intermediary scheme spanning 2005-2008.

Billions more were squandered because of gas subsidies. Official data shows that between 2005-2015 Ukraine may have lost \$53bn as a result of selling natural gas to households, district heating and religious establishments below market level.

The Stockholm International Peace Research Institute found that in 2014 alone, Ukraine spent more on gas subsidies than on military expenditure estimated at \$3.2bn that year.

Given the prodigious losses, it was imperative that after the Euro-Maidan revolution the new government should make the overhaul of the gas sector a priority.

It decided as part of its stand-by agreement with the IMF to eliminate the cap for industrial and commercial tariffs and gradually raise household tariffs to market levels.

Meanwhile, improving the governance of Naftogaz as the primary source of corruption and bolstering its autonomy was also secured as an independent supervisory board was brought in.

Once the overhaul of the economy and of the company was triggered in 2015, Naftogaz's prospects changed. In 2014, it accounted for 27% of state budget spending, but by 2018

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it contributed 14% of its revenues and has not relied on any state support since 2016, according to official data.

CURRENT SITUATION

With many loopholes closed, and reform triggered, the Ukrainian gas sector soon became a promising frontier market.

Its clean break with Russia following the annexation of Crimea and the war in the East prompted the country to discontinue its imports of Russian gas in 2015 and turn decisively towards Europe, committing itself to aligning its energy rules with the EU's free market principles.

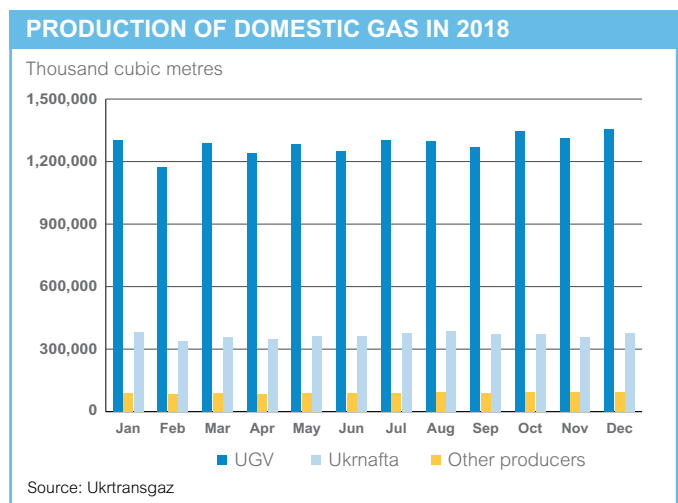
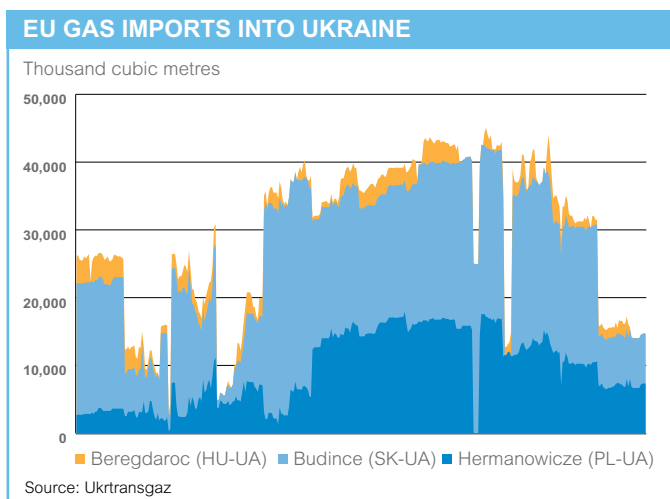
As a contracting party of the Energy Community, an institution established to bring the EU free market objectives to non-EU states, Ukraine pledged to unbundle its transmission operations, eliminate state subsidies, implement the EU's network codes and establish a liquid gas market.

Stopping Russian supplies, it also turned to neighbouring Hungary, Poland and Slovakia for gas imports, taking at the same time drastic measures to improve its efficiency as a means to reduce demand and boost local production.

Since then, much of the gas that was imported was bought by Naftogaz, but other companies also entered the market.

In 2018, the largest importers were the state company, the Ukrainian subsidiary of SOCAR, the Azerbaijani incumbent, and ERU, a Ukrainian company. Naftogaz itself bought from European suppliers such as Germany's RWE, Swiss-based Axpo, DXT, Vitol. In total around 40 companies imported gas into Ukraine in Q4 '18, according to customs data.

The decline in gas production by Ukgasvydobuvannya (UGV), a daughter company of Naftogaz, and leading producer, was reversed, leading to a 24-year high in 2017. By 2019, it also opened transparent online tenders for 30 oil and gas blocks across seven regions, hoping to increase production from the current 20.5bcm/year to 35bcm/year in 2035.



FAILURE TO SCRAP SUBSIDIES

Yet the two key issues that sit at the heart of the sector's regeneration – the elimination of subsidies and the independence of Naftogaz have still not have been completely reached.

Although Ukraine has succeeded in lifting the cap on industrial and commercial tariffs, and increasing the tariff for households, the latter still remain some 35% below market value. As of March 2019, some 60% of the gas sold in Ukraine is still subsidised.

Under current arrangements, Naftogaz sits at the centre of a public service obligation (PSO) whereby local gas producers have to sell volumes to Naftogaz, which is then required to sell it on to households, district heating companies and religious establishments at regulated tariffs below market value.

The IMF and the Energy Community have repeatedly urged Ukraine to phase out the subsidies but they remain in place because phasing them out would prove politically unpopular, particularly as Ukraine heads for elections.

Nevertheless, Naftogaz has argued that the incentives were benefiting distribution companies which were receiving the gas at cheap prices as part of the PSO, but were syphoning it off selling as much as 2bcm/year to other consumers at higher prices, effectively perpetuating the corrupt system.

Subsidies are doled out to distribution companies, known in Ukrainian as oblgazes, via their retail subsidiaries known as gazzbuts, rather than directly to consumers. This has allowed oligarch-run distribution companies to exploit the system by setting up fictitious consumer accounts, leading to a ballooning debt.

At the end of January 2019 distribution companies owed Naftogaz \$2.2bn, enough to fully finance the incumbent's 10-year modernisation, according to its CEO Andrey Kobolyev.

Furthermore, Naftogaz has argued that as long as the PSO is held in place and consumer tariffs remain below market value, the country could not switch from monthly ex-post to daily balancing as the latter would allow distribution companies to write off even more debt, with thousands of customers being unaccounted for. The balancing market was launched on 1 March, but some companies reported issues related to the record of consumers.

Others, however, had argued that Naftogaz was using this argument as a reason to delay or even block the balancing market in order to retain the status quo from which it would benefit.

ON 1ST MARCH 2019:

- 220 participants nominated on the balancing platform
- 35 of those were suppliers of last resort
- 279 nominations and renominations were verified by Ukrtransgaz

INDEPENDENCE UNDER THREAT

In recent months Naftogaz itself has been under increased political pressure. At the beginning of March, Clare Spottiswoode, the head of the supervisory board, pleaded with key international institutions to help ensure the integrity of Naftogaz' governance, which she said was under threat.

The letter came amid an escalating dispute between the board and the government led by Prime Minister Volodymyr Groysman over the continuation of the current Naftogaz CEO's tenure and his team after their contracts come to an end of 22 March.

Groysman was pushing to reject the extension of Andrey Kobolyev's contract for another three years, but the supervisory board suggested that under amendments to the law brought in 2017, the sole competence for appointing and extending the mandate of Naftogaz's executive team resided with the supervisory board. The law was changed in November 2017 after a first supervisory board resigned over similar allegations of political interference.

Even so, since 2017 the cabinet failed to align the Naftogaz charter with the legislative amendments, triggering the latest clash between the supervisory board and the government.

As this paper went to press, it was still unclear how the dispute would be solved. If allegations of political interference are proven and the integrity of Naftogaz's governance is under threat, the fact should raise red flags to domestic and European stakeholders.

There are already concerns that the regulator NERC does not enjoy full independence. In 2017, for example, at the request of the president and prime minister the watchdog

suspended its market-based gas distribution methodology that would have raised tariffs.

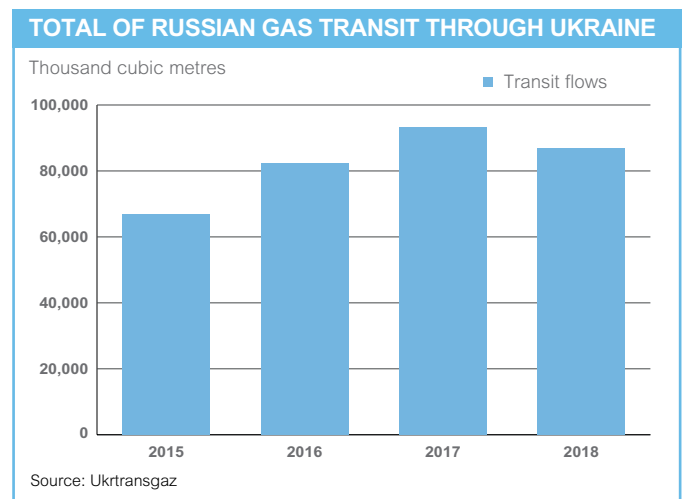
A study by the US-based Council on Foreign Relations argued in December 2018 that the situation was further compounded by the fact that the cabinet of ministers undermined the regulator by choosing not to publish the decision in *Uryadovy Kuryer*, the cabinet of ministers' official newspaper. Under current arrangements, NERC's official decisions cannot be enforced unless they are published in this gazette.

NAFTOGAZ ROLE

Preserving the independence of Naftogaz is critical not only as a safeguard against corruption, but also as the country seeks to define its position, should it be deprived of its role as Europe's key transit route for Russian gas. The resolution of the transit conundrum will also dictate whether Ukraine will carry out the much-needed unbundling of its transmission operations.

With Moscow clearing most EU legal hurdles towards the commissioning in 2020 of Nord Stream2, a 55bcm/year pipeline that would link Russia to Germany across the Baltic Sea, it is likely that volumes currently shipped to Europe across Ukraine would be diverted via the new corridor.

Nearly 40% or 93bcm/year of Russian gas were exported to Europe via Ukraine in 2017, allowing the country to collect over \$2bn annually in transit revenue, or 3% of its GDP.



If the transit route is discontinued, the country will not only lose an important source of revenue, but could also become more vulnerable geopolitically.

Ukraine observers have suggested that both Europe and Russia had been interested in upholding a reliable transit route via Ukraine. However, when the current long-term transit contract with Russia's Gazprom expires this year, Europe may no longer be directly interested in ensuring Ukraine's compliance with its rules, while Russia may seek

to intensify its war in the eastern Donbas region, potentially destabilising eastern Europe.

Of course, it is hard to predict how matters will develop in the long-term. A few things are clear, nonetheless.

Firstly, even if Nord Stream2 is commissioned next year, it is unlikely that transit will dry out completely from 1 January 2020. Generally, newly commissioned pipelines need a ramp-up period during which flows are brought to nominal values. This means that at least in 2020, Ukraine will still continue to offer transit for Russian gas, although, admittedly, at comparatively lower levels.

Secondly, much will depend on the upshot of upcoming trilateral negotiations between Ukraine, the EU and Russia in May, and in particular on changes that could occur on all three sides.

In February, Russia's Gazprom announced it had dismissed two top executives Alexander Medvedev and Valery Golubev, both of whom were involved in trilateral talks with Ukraine and were thought to be more amenable to negotiations with Kyiv. Their replacements are yet to be announced.

In March, Ukraine itself may follow suit, changing the executive team of Naftogaz, while the EU prepares for parliamentary elections in May.

Thirdly, even if Ukraine is completely deprived of its transit role Naftogaz, which has held the transit contract with Gazprom, will have to ensure that the country develops a flexible market that guarantees imports and exports to and from Europe and attracts foreign companies to take advantage of its 31bcm storage facilities. This should guarantee a stable stream of revenue.

In recent years the transit of Russian gas via Ukraine has been the subject of much debate in the country and abroad, particularly after Naftogaz won an arbitration case against Gazprom for under-delivered gas.

The award by the Stockholm Arbitration Tribunal requires Gazprom make a \$2.6bn net payment to Naftogaz. However, Gazprom disagreed with the decision last February, threatening to discontinue the transit to Europe ahead of schedule and refusing to supply gas to Naftogaz from 1 March 2018 as required under the decision of a separate arbitration by the same tribunal in December 2017.

Naftogaz subsequently initiated a new \$12bn arbitration against Gazprom in July 2018 in which it requested the retroactive revision of the transit tariff with Gazprom from March 2018. It is also seeking to arrest Gazprom's assets in various European jurisdictions, as a means to recoup the \$2.6bn that the Russian producer owes under the transit arbitration award.

UNBUNDLING

The resolution of all these lawsuits as well as the changes that will take place in the upcoming weeks – the replacements of Medvedev and Golubev at Gazprom, the decision regarding the management of Naftogaz and the new EU administration – would determine the fate of Ukraine's transit role.

It would also dictate how and when Ukraine would unbundle its transmission operations, a reform milestone that has been postponed since 2016.

Naftogaz as the mother company of the gas grid operator Ukrtransgaz argued that the divestment and the transfer of transmission operations to a new independent TSO was impossible until the end of 2019, as the current transit contract was signed by Naftogaz and Gazprom and that the latter would not agree for this contract to be transferred to a new entity.

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However, as the transit contract is approaching its expiry date, Naftogaz announced the creation of a new transmission system operator that will sign interconnection agreements with European and Russian grid operators.

At the beginning of February Naftogaz, which owns TSO Ukrtransgaz, said it had accepted the establishment of a new transmission entity called TSO of Ukraine.

Earlier plans drafted in 2016 suggested that Ukrtransgaz operations could be transferred to a new company called MGU after full unbundling in 2020.

Following the latest changes, the new entity established in February could operate under the umbrella of MGU and would apply for certification from energy regulator NERC in July to comply with the EU unbundling rules.

The next step is for the new TSO to negotiate two agreements with Gazprom.

The first would be an interconnection agreement with the Russian company, which is also the grid operator. The second would be with Gazprom as a shipper of natural gas.

The new Ukrainian gas grid operator would also have to sign new interconnection agreements with neighbouring countries including Hungary, Poland, Romania, Slovakia and the question that needs to be answered is whether the off-take points for Russian gas would be on the Ukrainian-Russian border or on Ukraine's borders with EU member states. Ukraine insists that the transit of natural gas would be in line with EU rules and network codes stipulating third party access.

In this context, the new Ukrainian interconnections agreements will have to abide by the transparency rules prescribed by the EU's network codes and third energy package.

ELECTIONS

As Ukraine approaches the first round of presidential elections on 31 March, it is clear that the winner will have to pay particular attention to reform in the natural gas sector.

His or her priorities will be to guarantee the elimination of the country's onerous subsidies system, consolidate the independence of Naftogaz and the regulator NERC and ensure Ukraine retains a transit role post 2019.

However, a scan of the current candidates' manifestoes shows that hardly any of the contenders would seek to bring real change.

With less than a month to go, the race is proving a surprise not only because a staggering number of candidates are vying for the top position, but also because out of the 44 contenders, a comedian with no political experience and no political programme is increasingly tipped to win.

Only two months ago the race was seen as a likely confrontation between the incumbent Petro Poroshenko, the owner of a large-scale confectionery company, which earned him the nickname "chocolate king" and Yulia Tymoshenko, a former prime minister also known in the western media as the "gas princess" for her role in brokering a gas deal with Russia for which she was convicted in 2009.

With Volodymyr Zelensky joining the electoral race at the beginning of the year, polls indicate that archrivals Poroshenko and Tymoshenko who, at the beginning of March, were tipped to get around 16% of the votes each may lose to Zelensky who was polling at 25%.

Even more surprising is that opinion poll institutes indicate that the former comedian and TV producer may carry the second round of presidential elections scheduled for 21 April.

Zelensky could still see a reversal of fortunes as election day approaches, but if current polls turn out to be true, his success would be a remarkable protest vote from a country exhausted by corruption and political infighting.

Yet, despite Zelensky's popularity as a comedian who has built a reputation by attacking the political class, there is little ideological substance and structure to guarantee Ukraine's commitment to reform after 2019.

He has so far steered clear of media interviews or sending out political messages, relying solely on this fame as an actor who once played the president of Ukraine in a hit TV show.

This vacuum could have serious implications in the aftermath of the elections, because, as a paper by Carnegie Europe, a think tank, observed, a flurry of political interests will attempt to fill it.

The domestic media is rife with allegations that he is supported by Ihor Kolomoyskyi, a powerful oligarch who

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along with other business groups reportedly brought legal cases with regards to the storage of natural gas, and which could impact whether Naftogaz's transportation and storage assets should be unbundled.

The Kolomoyskyi group was allegedly claiming 10bcm of gas as compensation covering the period 2006-2012 for 12bcm produced by Ukrnafta where Kolomoyskyi was holding minority shares. The 12bcm were accumulated by Naftogaz for storage. The government ordered the sale, but Ukrnafta, where Naftogaz is a shareholder, reportedly refused to confirm the sale. The Kolomoyskyi group won a claim in Ukrainian courts at all levels for 2.08bcm of gas, but 10bcm are still disputed.

This, according to a study by the Oxford Institute of Energy Studies (OIES) could make storage assets toxic and impact the outcome of the unbundling process.

Zelensky's putative association with Kolomoyskyi may therefore raise questions about his commitment to gas reform and in particular to the unbundling of storage and transmission assets.

Questions should also be raised about Yulia Tymoshenko's interest in market liberalisation. The leader of the "Fatherland" party is pro-European and has built a reputation for co-leading the Orange Revolution protests against corruption in 2004. But over the years, the two-time prime minister was herself convicted of using political influence to sign a gas deal with Russia and observers point out to possible ties to Moscow, even if officially no candidate campaigns on a pro-Russia platform.

Most importantly, she has taken a populist stance, promising to decrease gas tariffs to households, even if publicly she argues that she remains committed to abiding by the terms of the IMF-supported reform programme, which conditioned the disbursement of a \$17.5bn aid package and a \$3.9bn credit line on the reduction and ultimately elimination of gas subsidies.

On the other hand, the other front-running contender and current incumbent, Petro Poroshenko came to power in 2014 and triggered the current reform programme, which also extends to the gas sector.

He affirmed Ukraine's pro-EU and NATO stance, amending most recently the constitution, committing the country to become a member of both organisations.

Yet, reform has stalled in the last few months as well as the fight against corruption and the president, who established a national anti-corruption bureau (NABU), was himself alleged to have been linked to corrupt deals. Poroshenko has denied the claims.

CONCLUSION

The stakes of the upcoming elections are high, but there are indications that the front-running candidates are hardly prepared to take them on.

Although, in theory, a priority for any politician looking to strengthen the economic stability of the country and clamp down on corruption, removing gas subsidies would be difficult to enact. The move would be highly unpopular with voters who struggle to pay their bills as well as with powerful oligarchs who benefit from the scheme.

This means that the political interest in retaining control over Naftogaz as the main pillar of the subsidies scheme and of the watchdog as the enforcer of regulations would remain high, potentially leaving both institutions to ward off the threat of political interference.

A weak Naftogaz, vulnerable to political interference may also find itself hamstrung in negotiations with Russia over the transit of gas after 2020 and the role that Ukraine could take in the wider European energy dynamics.

Unlike in 2014 when it benefited from the support of Washington and Brussels, Ukraine currently faces the headwinds of populism that has left the US and many European countries more inward looking.

On the plus side, many energy and foreign policy analysts recognise that political and economic turmoil in Ukraine could create instability in Eastern Europe and, for that reason, no effort should be spared to support Kiev's commitment to reform.

Ultimately, the decision will belong to the Ukrainian people as they head to the polls this month.



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