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SWOT ANALYSIS
OF THE MODELS OF RESTRUCTURING OF THE GROUP NJSC NAFTOGAZ OF UKRAINE
AS A RESULT OF UNBUNDLING OF THE NATURAL GAS TRANSPORTATION FUNCTION AND ASSETS

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ABBREVIATIONS:

3EP Third Energy Package
CBEP central bodies of executive power
CMU Cabinet of Ministers of Ukraine.
GTS gas transportation system
MECIU Ministry of Energy and Coal Industry of Ukraine
MEDTU Ministry for Economic Development and Trade of Ukraine
MGU PJSC MGU
NJSC National Joint-Stock Company
SPFU State Property Fund of Ukraine
SWOT Strengths, Weaknesses, Opportunities, Threats
UGS underground gas storage (facilities)
UGV PJSC UkrGasVydobuvannya
UTG PJSC UkrTransGaz
PROJECT DESCRIPTION, CONCLUSIONS AND RECOMMENDATIONS

OBJECTIVE AND METHODS

The objective of this report is to enhance the awareness of stakeholders of the strengths and weaknesses of the two models of restructuring of the group NJSC Naftogaz of Ukraine as proposed by the Ministry of Energy and Coal Industry of Ukraine and by NJSC Naftogaz of Ukraine. In order to ensure complete and effective implementation of the Third Energy Package and further opening of the market, the selection of any of the following models should consider both opportunities and risks of their implementation. This report presents a list of such risks and opportunities.


The DiXi Group experts employed the SWOT analysis technique to analyze the proposed models. Each model has been analyzed from the standpoint of available and potential opportunities, threats, strengths, and weaknesses. However, the experts deliberately do not give preference to any of the models since both generally comply with the European legislation and respective Ukrainian law, and the choice between them is more a political decision of Ukrainian authorities and politicians rather than identification a more or less European-style model.

The structure of the report is as follows: presentation of each model, list of the available and potential opportunities, threats, strengths, and weaknesses, followed by a detailed description of each. Specific sections provide details of the distribution of control over the GTS operator (the TSO), UGS operator (the SSO), and other assets among state authorities (the Cabinet of Ministers of Ukraine, Ministry of Economic Development and Trade of Ukraine, Ministry of Energy and Coal Industry of Ukraine, and State Property Fund of Ukraine).

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2 Naftogaz proposed a plan of action to fully separate the operator of the gas transportation system of Ukraine. – April 1, 2016. - http://www.naftogaz.com/www/3/nakweb.nsf/0/308F893DE793AC225F8004AEC0?OpenDocument&year=2016&month=04&nt=%D0%9D%D0%BE%D0%B2%D0%B8%D0%BD%

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GENERAL COMMENTS AND RECOMMENDATIONS

The analysis of the two models revealed a number of common observations and warnings that need to be taken into account when deciding in favor of a particular model. These include:

1. Both models are fully compliant with the Third Energy Package regarding the unbundling of the transportation function from the gas production and supply business. Whereas in the model of NJSC Naftogaz of Ukraine, the gas transportation operator is subordinated to the State Property Fund of Ukraine, in the model of the Ministry of Energy, this operator is subordinated to the Ministry of Energy and Coal Industry. In both models, the operator is removed from the structure of the vertically-integrated company and is no longer tied to it by managerial, financial, and legal connections in accordance with the Directive.

   Article 9 of Directive 2009/73/EC
   1. Member States shall ensure that from 3 March 2012:
      a) each undertaking which owns a transmission system acts as a transmission system operator;
      b) the same person or persons are entitled neither:
         (i) directly or indirectly to exercise control over an undertaking performing any of the functions of production or supply, and directly or indirectly to exercise control or exercise any right over a transmission system operator or over a transmission system; nor
         (ii) directly or indirectly to exercise control over a transmission system operator or over a transmission system, and directly or indirectly to exercise control or exercise any right over an undertaking performing any of the functions of production or supply;
      c) the same person or persons are not entitled to appoint members of the supervisory board, the administrative board or bodies legally representing the undertaking, of a transmission system operator or a transmission system, and directly or indirectly to exercise control or exercise any right over an undertaking performing any of the functions of production or supply; and
      d) the same person is not entitled to be a member of the supervisory board, the administrative board or bodies legally representing the undertaking, of both an undertaking performing any of the functions of production or supply and a transmission system operator or a transmission system.

2. Both models comply with the “ownership unbundling” format which is recommended by the EU and provided for in Directive 2009/73/EC, as well as in the Law of Ukraine “On the Natural Gas Market” (Article 23). Both models, of Naftogaz of Ukraine and of the Ministry of Energy, provide for removing the gas transportation system assets from the structure of the vertically integrated company, no single shareholder for the generation/supply and transportation company, and no same persons in the management of the generation/supply and the transportation arms. The only thing is that in the first case, the shares of the operator will be transferred for management to the State Property Fund of Ukraine, while in the second case, they will be managed by the Ministry of Energy.

3. The key task when choosing between the models is to determine the place in the structure of NJSC Naftogaz or outside of it for the gas storage system operator (UGS operator) and gas production companies, primarily PJSC UkrGasVydobuvannya. To determine this place means not as much to comply with the requirements of Directive 2009/73/EC as to form a vision of gas market liberalization, its openness for foreign investors, and stimulating the competition. This is the reason why it is so important to ensure that the final choice of NJSC Naftogaz of Ukraine reorganization model is a result of extensive discussions and consensus among stakeholders on a development strategy of Ukraine’s gas market.

   Preamble of Directive 2009/73/EC, para. 24: “It is necessary to ensure independence for operators of storage systems to improve third party access to the storage facilities that are needed technically and/or economically to provide effective access to the system to supply gas to consumers. It is, therefore, necessary to make the storage facilities to be operated by legally separate entities that have effective decision-making rights to the assets that are needed to maintain, operate, and develop these facilities. It is also necessary to improve transparency in everything related to the storage capacity offered to third parties ... ”

   Preamble of Directive 2009/73/EC, para. 9: “The separation system shall be effective for settling any conflict of interests between producers, suppliers, and transportation system operators to create incentives for the needed investments and guarantee access for new market operators under a transparent and effective regulatory regime and shall not create an excessively onerous regulatory regime for national regulatory authorities.”

4. Among the most important factors for the successful unbundling process there is the independency the new companies will obtain. Regardless of the model chosen, expert and candid composition of such companies’ supervisory boards, as well as the maximum level of their discretion, is the key requirement.
The difficulty point in both models is that the gas transportation operator will remain subordinated to state executive authorities. This is a requirement, as the applicable legislation of Ukraine requires that gas transportation and storage assets remain in state ownership. This also does not violate the requirements of Directive 2009/73/EC and EU practice. However, the current system of official subordination within the executive branch leaves the discretion to the Prime Minister at will to influence the members of the government who control gas transportation and production/supply operators. The legal status of the government members and the Head of the State Property Fund significantly coincide in terms of interaction with the Prime Minister; therefore, this issue is relevant to both models and needs further discussion and legal analysis.

Article 42 of the Law of Ukraine “On the Cabinet of Ministers of Ukraine.”

1. Prime Minister of Ukraine:
1) ...
2) directs, coordinates, and controls the activities of the members of the Cabinet of Ministers of Ukraine, heads of other central bodies of executive power [the SPFU is such a body - the authors’ note], Council of Ministers of the Autonomous Republic of Crimea, local state administrations, issues for this purpose instructions, which are binding on the said bodies and officials...

Article 3 of the Law of Ukraine “On the State Property Fund of Ukraine.”

1. The State Property Fund of Ukraine is governed in its activities ... by instructions of the President of Ukraine and Prime Minister of Ukraine...

5. Both models require several stages to pass to become implemented. Therefore, when choosing between the models, it is important to control that these stages are passed without delays throughout the “transitional” periods. Both models further provide for some secondary legislation to be additionally developed, in particular: in the model of NJSC Naftogaz of Ukraine, such regulatory acts will separate the activities of this company and PJSC UkrTransGaz that will remain a UGS operator under its control, whereas in the model of the Ministry of Energy and Coal Industry, additional and detailed regulation is necessary to limit the political influence of the Ministry on the activities of UkrTransGaz as a transportation and storage operator. All this requires control and monitoring over the model implementation on the part of third parties (donors, MPs, and experts), and at the same time, publicity and transparency of each reform stage on the part of NJSC Naftogaz of Ukraine and the government.

6. The key problem is the future of the underground gas storage facilities (UGS). Naftogaz’s suggestion is to remain it within this company’s control and to partially privatize storages in the future. The Ministry of Energy’s model provides for keeping UGS and GTS joined and under the control of the TSO, with possible further separation subject to a dedicated assessment. However, in order to choose the optimal model, it is already expedient to estimate the strategic value of the UGS for transportation to the western borders, to identify which amount of storage is required for securing the nation’s interests and energy security. Deciding on the future of the UGS must be well-grounded and argumented.

7. This paper does not take into consideration the ongoing arbitral proceedings between NJSC Naftogas of Ukraine and PJSC Gazprom at Stockholm Chamber of Commerce as currently there is insufficient amount of open data on how exactly this arbitration may influence the unbundling process. What is certain, any model of such unbundling would entail consequences for transit contract entered into between the parties in 2009, as well as the credit facility opened for NJSC Naftogaz of Ukraine. It is estimation of Naftogaz that the time required before their unbundling model could begin to implement equals 12-18 months, which reflects the terms for the arbitration to complete. The Ministry’s model is capable of quicker implementation, however, the arbitration factor must not be neglected as well.

8. Political will remains a key factor for the successful implementation of both models. Neither of them provides for the guarantees and effective safeguards against political influence or manipulation by senior officials during market operation. Thus, in any model, if desired, it is possible to “roll back” and distort the implementation of the Third Energy Package through political influence.
on market participants. This risk should be taken into account by all stakeholders in monitoring the gas market reform and restructuring of NJSC Naftogaz of Ukraine.

9. Regardless of which model will be chosen and given the importance of NJSC Naftogaz of Ukraine as the largest player of Ukraine’s oil and gas market, the impact of the reorganization of NJSC Naftogaz of Ukraine on further liberalization of the gas sector, it is expedient to set up a working group composed of representatives of all stakeholders, including members of various parliamentary factions, donors, and experts for further supervision over implementing the chosen model. A special MP commission with respective powers and competent personal composition could be an effective form for such a working group. The task of the Commission should be to control over compliance with the model implementation schedule and adequacy of the steps taken by the government and the company for the changes the chosen model provides for.
MODEL SUGGESTED BY NJSC NAFTOGAZ OF UKRAINE

STRENGTHS 1

THE MODEL COMPLIES WITH THE REQUIREMENTS ON THE OWNERSHIP UNBUNDLING TERMS.

Of the three options permissible under the Directive and of the two options provided for by the Law “On the Natural Gas Market,” the restructuring model proposed by NJSC Naftogaz of Ukraine is generally in line with the recommendations of the European Commission. It provides for ownership-based separation of the gas transportation activities ("ownership unbundling").

Despite the formal preservation of PJSC UkrTransGaz, which is currently the GTS operator within the structure of NJSC Naftogaz of Ukraine, the assets in the form of trunk gas pipelines and relevant functions are proposed to be transferred to a newly-established operator, which will be subordinated to the State Property Fund of Ukraine. This will fully satisfy the requirements of the priority restructuring format set forth by the Energy Community and EU institutions.

STRENGTHS 2

GREATER INDEPENDENCE OF MGU SINCE THE MOMENT OF ITS CREATION.

GTS OPERATOR IS A NEW COMPANY WITHOUT THE “INSTITUTIONAL MEMORY” FROM THE PAST.

It is proposed to that a newly-created company (tentatively named PJSC MGU) becomes the GTS operator, which theoretically makes it possible, provided there are political will and the necessary consensus of all stakeholders, to develop such policies, procedures, and standards, which ensure not only formal and legal independence of the operator, but practically implement all the requirements for an independent operator.

It will be impossible to create a new company whose only mission will be to control the gas transportation system of the country without developing necessary rules and, possibly, secondary legislative acts. Given the proper political will, PJSC MGU can do this based on the best gas transportation practices. Creating a new company without “institutional memory” of being a unit of the vertically-integrated oil and gas company with a clean reputation may be a more efficient move than comprehensively reforming the operating activities of PJSC UkrTransGaz. Importantly, this is mostly applicable to the top management
level of the company. Additionally, this advantage is crucially dependent on the way PJSC MGU is to be created, as much as currently it is proposed to be established and operated for some time within the Naftogaz group of companies.

*The model of its own restructuring proposed by Naftogaz opens the possibility, under certain conditions, to set quality standards of independence and integrity of the GTS operator right from the outset.*

**STRENGTHS 3**

**SEPARATION OF THE TRANSPORTATION OPERATOR FROM ANY OTHER ACTIVITY WILL ENHANCE ITS TRANSPARENCY AND ECONOMIC ATTRACTIVENESS.**

The separation of the transportation operator from the gas storage operator will optimize its operations, structure, and possibly the staff. PJSC MGU will be effectively unable to exercise any form of cross-subsidy between various businesses, which will make the company more transparent in its activities and further improve its investment attractiveness.

Among other things, the report of the World Bank consultants recognizes the complete unbundling of all individual functions in the gas sector (transportation, storage, production, supply/trade) as the most appropriate and desirable reform result, although attributing it to a longer phase of restructuring estimating it to take approximately 3 to 5 years.  

In addition, according to the experts, the EU market of gas storage services remains (and will remain for the next 2-3 years) depressed. In 2010 to 2015, a capacity of 2.7 bn. m³ was decommissioned. Oftentimes, the gas storage prices set by national regulators are excessive as compared with the actual supply and demand balance, and in a competitive market, participants may refuse these services. As a result, this business in the EU even happen to be subsidized. However, this assessment is for the next 5 years only, while the longer term forecast is, in general, opposite.

*Complete separation of the transportation operator from other businesses, even the storage business, is a more ambitious, yet effective plan.*

**STRENGTHS 4**

**AN OPPORTUNITY FOR PJSC UKRGASVYDUBOVANNYA TO BETTER PREPARE FOR THE CLOSING OF THE REGIME OF SPECIAL DUTIES AND POSSIBLE PRIVATIZATION.**

NJSC Naftogaz of Ukraine performs the function of marketing the products of PJSC UkrGazVydobuvannya. If UGV remains within the group, it will get extra time to prepare for the planned equalization of prices in 2017 and possible privatization in the future.

Currently, NJSC Naftogaz of Ukraine buys out all or close to all the gas produced by PJSC UkrGazVydobuvannya at a fixed price and directs it to satisfying the needs of households, receiving the corresponding compensation from the state budget.

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1 Analysis of the Restructuring Options of NJSC Naftogaz of Ukraine - Unbundling options for gas transmission and storage, February 2016, Key recommendations, slide 1.

According to the strategic vision of NJSC Naftogaz of Ukraine, it is advisable to privatize PJSC UkrGazVydobuvannya after the regime of special duties\(^3\) is over and when, respectively, the appropriate market price for the company’s assets is reached. By that time, UGV should undergo modernization, and get gradually privatized within the next 3-4 years thereafter, that is, by 2020.

*If the company is left under the control of Naftogaz, it may be better off implementing its ambitious development program until 2020 than transferring into the holding whose format is yet to be determined.*

At the same time, the model of NJSC Naftogaz of Ukraine does not document the privatization commitments. That is, this issue will remain open and left to the discretion of the NJSC management after the expiration of the regime of special duties.

### STRENGTHS 5

**THE MECIU DOES NOT ACQUIRE THE ROLE OF DIRECT SHAREHOLDER OF STATE PROPERTY, A FUNCTION IMPROPER FOR IT.**

If the holder of corporate rights in the transportation operator is the State Property Fund, which is not involved in the formation and implementation of the energy sector policy, this will reduce the risk of political influence on the operator and, accordingly, threat to its independence.

In order to increase the investment attractiveness of the sector, it is obviously desirable to limit the roles of the state in the oil and gas business between its capacities of a subsoil use rights granter, a business entity, a regulating authority, etc. Currently, prohibition on GTS and UGS privatization prevents complete elimination of the threat of political influence through privatization of the GTS and UGS assets. However, according to the OECD Guidelines on Corporate Governance of State-Owned Enterprises,\(^4\) it is desirable to ensure as much as possible independence of state authorities, especially the Ministry of Energy, in their activities in various competencies. In this case, this will be supported by preventing the MECIU from acquiring property rights in a business entity. Despite the fact that the GTS and UGS are, at the moment, close to represent natural monopoly assets, which to some extent limits the Ministry’s ability to affect competition, distorting the market, this possibility may emerge in the future on the market of gas storage services, considering the Ministry’s plans for further partial privatization of the gas storages. Thus, regardless of the specifics of the SPFU as a public body, *selecting any entity other than the MECIU as a direct shareholder for the GTS operator is in line with the general logic of modernization of the public administration system, specifically, the state power liberalization and decentralization vector.*

### WEAKNESSES 1

**THE VERTICAL INTEGRATION OF NAFTOGAZ REMAINS, REQUIRING ADDITIONAL RULES AND REGULATIONS TO BE DEVELOPED.**

If the UGS assets are preserved in the structure of the Naftogaz group, the company will remain vertically integrated in the meaning of the Directive.\(^5\) The Third Energy Package allows such a scheme,

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\(^{3}\) CMU Resolution No. 758 of October 1, 2015 introduced a price ceiling for gas sold to households, effectively limiting the pricing for the gas produced by UGV and marketed through Naftogaz until April 2017.


\(^{5}\) Article 2.20 of Directive 2009/73/EC provides for the production and supply functions to be kept in the same group with the gas storage function as one option for
but it requires a special system of internal corporate rules and acts of secondary legislation to be developed to ensure independence of PJSC UkrTransGaz as a UGS operator in the structure of Naftogaz Ukraine.

The model of NJSC Naftogaz requires that the gas transportation operator functions and assets be removed from the holding structure, but the gas storage operator remained in the holding company. For the latter purpose, both the Directive and the Law “On the Natural Gas Market” provide a rather complex system of rules and regulations designed to secure sufficient independence of the UGS operator from the influence of the persons and companies engaged in the gas production and supply activities inside of the company. In particular, the Directive forbids the combination of the UGS operator management positions with those in other units of the group, provide for the development of measures guaranteeing that the professional interests of the operator are taken into account, it has the appropriate level of authority relating to the assets, etc.

Thus, the restructuring on the conditions proposed by Naftogaz will require additional time and effort to develop such standards.

**WEAKNESSES 2**

RETENTION OF THE SERIOUS INFLUENCE OF NJSC NAFTOGAZ OF UKRAINE ON THE GAS MARKET AND POSSIBLE NON-TRANSPARENT MANAGEMENT IN THE COMPANY.

The Annual Report of NJSC Naftogaz of Ukraine for 2014 evidences that when the gas transportation activity (31 percent of the total result) is taken out of the group’s structure, only a relatively small share of oil business (10 percent) will remain in the operating field of Naftogaz in the non-regulated segment. This makes the company’s operations in the regulated sector more than significant (59 percent), meaning gas trade, production, and storage.

NJSC Naftogaz of Ukraine formally commits itself to furthering the restructuring by dismantling the vertical integration through gradual privatization of all assets apart from those necessary to carry on with its obligations as the supplier of the last resort. The model proposed by Naftogaz of Ukraine does not, however, impose any unconditional obligations regarding such privatization of other assets. If such obligations are not included in the current model, Ukraine may miss an auspicious moment in reforming the sector and delay in creating possible competitive markets. Instead, NJSC Naftogaz of Ukraine will remain a vertically-integrated company with a great potential for influencing the market. Among other things, this influence will be spelled through keeping control over PJSC UkrGazVydobuvannya, that is major gas production market player, until its complete privatization currently scheduled at 2020s.

Due to the existing vertically-integrated structure of Naftogaz and cross-subsidization of various operation segments, there is the lack of transparency in the use of budgetary appropriations, and therefore, their effectiveness is questionable. This point is confirmed by company audit reports.

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8 Materials of NJSC Naftogaz of Ukraine to the roundtable meeting of February 19, 2016, slide 17.
WEAKNESSES 3

GAS TRANSPORTATION SYSTEM WITHOUT UNDERGROUND STORAGES MAY PLAY A LESSER STRATEGIC ROLE, PARTICULARLY FOR THE PURPOSE OF UNINTERRUPTED GAS SUPPLY TO THE EU.

If a foreign investor is interested in participating in GTS management to ensure uninterrupted gas supply to the EU and the UGS is an important element of the supply chain, the separation of the storage facilities may reduce the interest of such investor in the GTS.

As of now, there is no openly available information about the part the UGS plays in Ukraine’s performance of its obligations to transport Russian gas to the EU borders. Based on the publications10 that refer to the Technical Agreement between NJSC Naftogaz of Ukraine and PJSC Gazprom, the UGS are needed to perform the existing contract of gas transportation to the EU borders, as long as the so-called “transaction day” (24 hours), which is given for the delivery of gas from the entering points to the European buyer, does not coincide with the duration of physical transmission of gas across the territory of Ukraine (36 hours), and this feature allows the contracting parties to interpret differently clause 2.8 of the Technical Agreement. However, it is unknown whether this situation will change after the contract expires.

Moreover, according to available information, the gas transportation system itself is capable of balancing only during one operational day. If the UGS remain an important component for Russian gas delivery to the western borders, the separation of the systems create a negative impression in terms of transit reliability and indirectly affect the interest of European investors in a strategic GTS management partnership. This is because in this case their participation in the management will not make it possible for them to secure gas transit across Ukraine independently from the other local parties.

The geopolitical significance of Ukraine’s GTS is difficult to evaluate in figures. However, according to the annual report of NJSC Naftogaz of Ukraine for 2014, the value of the gas transportation system assets amounted to UAH 239.7 billion or 46.5 percent of the total volume of assets of the group, and the value of the UGS added to that amount UAH 146,2 billion or additional 28.4 percent.11 Thus, when deciding on approaches to be taken to Naftogaz restructuring, the consequences for the capitalization of such major state assets should be carefully weighed.

WEAKNESSES 4

THE SPFU DOES NOT RESOLVE THE PROBLEM OF COMPLETE INDEPENDENCE FROM THE GOVERNMENT VERTICAL.

The SPFU is a central body of executive power with a special status, its primary purpose is to implement the government privatization policy and related tasks.12 At the same time, the SPFU, similarly to the ministries, in some situations may be dependent on the political influence of the Prime Minister, which retains the same risks as the model of the GTS operator’s subordination to the Ministry of Energy.

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11 Annual Report, Naftogaz at a Glance, Page 1
Considering the arguments of Naftogaz that SPFU has certain advantages in terms of formal protection from interference in its activities on the part of other authorities, it is important to note that given the current distribution of powers, the Head of SPFU and the Minister of Energy and Coal Industry, in their capacities as the heads of central bodies of executive authority, are equally required to comply with the instructions given by the Prime Minister of Ukraine.13

The procedure for appointing the Head of SPFU is generally the same as that for appointing Cabinet of Ministers’ members in which the Prime Minister pays the key role.14

Thus, the full compliance with the requirement to eliminate direct or indirect concurrent control over the GTS operator and other businesses (gas production or gas supply) will require amendments to the legislation in both proposed models.

In the absence of a chosen model of corporate governance reform for state-owned companies, it is impossible to assess how independent of the direct shareholder will the supervisory board or other governing body of PJSC MGU be.

**WEAKNESSES 5**

**SIGNIFICANT TIME IS NEEDED TO APPRAISE THE GTS AND THE UGS SEPARATELY, AS WELL AS FOR A NEW GTS OPERATOR TO BE CREATED.**

The separation of the GTS and UGS operators means separation of not only the assets, but also the staff, operational information, service and maintenance departments, etc. There is no exact information about the depth of interaction between these teams as of now, but this process requires a long time and support from NJSC Naftogaz of Ukraine. According to the expert assessments, it would take at least 2 to 4 years to create a fully independent TSO.

The gas transportation complex of Ukraine has never been divided into the transportation and storage arms, always remaining under the operational management of a single operator which, in turn, was part of a vertically integrated state giant. This format makes it complicated to access to the details of functioning of each of the two parts and makes it impossible to do feasibility study of the individual components. At present, the whole GTS has only been appraised as an integrated property complex and, according to Baker Tilly, its value in 2013 equaled USD 20-26 billion15, whereas some experts valued the GTS at USD 61 billion16.

Although the World Bank consultants have confirmed in their report that technically the systems are managed separately, but at the same time, they recognized the complexity and considerable time required for a complete and meaningful separation. To commence this complex work along with other reform stages may prove especially difficult in terms of the time required and quality implementation.

If the newly-created transportation operator MGU receives the core staff and management of PJSC UkrTransGaz, the factor of close personal ties with NJSC Naftogaz of Ukraine will remain, which is undesirable.

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13 The Law of Ukraine “On the Cabinet of Ministers of Ukraine,” Clauses 1, 2 of Article 42.
14 The Constitution of Ukraine, Clause 12 of Article 85.
If PJSC MGU recruits a completely new staff, this will consume more time and, most importantly, require the willingness of UkrTransGaz to transfer the necessary information and unique expertise.

In addition, Naftogaz’s presentation envisages that the “technical maintenance department” will remain in the structure of PJSC UkrTransGaz. Until no respective exhaustive explanation are given, this may mean that Naftogaz intends to leave under the control of UkrTransGaz all the technicians who service both the GTS and UGS, although Naftogaz itself denies such intentions.

This approach not only contradicts to the declared intention of UkrTransGaz to optimize the staff, but more importantly, will potentially retain its major control, and accordingly, the control of the Naftogaz group over operations of the newly-established GTS operator and potential owners and operators of privatized UGS.

**OPPORTUNITIES 1**

**HIGHER COMMERCIAL ATTRACTIVENESS OF THE GTS WITHOUT UGS AS PURELY BUSINESS ASSETS.**

The positive commercial result of the GTS makes it an attractive investment. The unprofitable performance of most UGS facilities and a generally negative situation on the market of gas storage services in the world and in Europe will reduce this attractiveness if the systems remain combined.

According to the annual report of Naftogaz for 2014, the operating income from the services of international natural gas transportation amounted to UAH 16.8 billion. The revenue from domestic transportation added another UAH 7.4 billion. Thus, the total revenue equaled UAH 24.2 billion. On the other hand, the gas storage business generated a total of UAH 1.4 billion in revenues. After deducting operating costs, the net financial result of the transportation activity in 2014 was a profit of UAH 7.5 billion, while the result of gas storage operations was a loss of almost UAH 3 billion.\(^\text{17}\)

The relatively stable and profitable gas transportation business with no need to cover both operating losses of gas storages and raise funds to upgrade them will increase the interest of potential investors. It should be noted, however, that one of the factors of the loss-making performance of the UGS is a low gas price which acts as a variable in calculating storage fees, as well as a high level of operating outlays (by comparing the operating income and loss before tax for 2014, the outlays are estimated at UAH 4.4 billion). Thus, there is a chance for the situation to improve as a result of a possible further increase in the weighted average gas prices and lower costs, including due to a more accurate gas metering and tracking and modernization of the storage facilities about which there is no full information.

OPPORTUNITIES 2

NO SIGNIFICANT LEGAL TRANSACTIONS WITH GTS ASSETS NEEDED. PROBABLE ABSENCE OF TAX EFFECTS.

In legal terms, the GTS is currently already owned of the State Property Fund. Therefore, in the model proposed NJSC Naftogaz of Ukraine, it is possible to save time and the money by not paying taxes for transferring assets between authorities.

As of now, UTG’s operation of the gas transportation system of Ukraine is based on a system of agreements between NJSC Naftogaz of Ukraine, PJSC UkrTransGaz, and the SPFU. In particular, there is Agreement No. 76 of February 4, 1999 between the State Property Fund and Naftogaz on the use of state property that is not subject to privatization, and Agreement No. 19/275 of June 17, 1999 between Naftogaz and UkrTransGaz (then in the previous legal form).

Thus, there will be no need to transfer state assets of the GTS to another public authority in Ukraine. Accordingly, time can be saved at one stage of restructuring, and also no additional tax liabilities will be created in connection with the transfer of the assets which as of 2014 cost nearly UAH 240 billion.

OPPORTUNITIES 3

EMERGENCE OF A COMPETITIVE NATURAL GAS STORAGE MARKET.

The proposal of Naftogaz that the storage facilities, which prove to be attractive enough for investors, be privatized will create conditions for the emergence of competition.

According to the updated diagrams showing natural gas storage volumes of UkrTransGaz, the maximum volume of gas accumulated before the heating season totaled approximately 16.8 bn. m³ in October 2014 and 17.1 bn. m³ in October 2015. Thus, of the total volume of approximately 31 bn. m³, a third remains spare at the peak need for strategic gas stockpiles for Ukraine’s domestic consumption.

NJSC Naftogaz of Ukraine proposed running a detailed economic and strategic assessment and technical justification, which is to be used in the future to carry out the planned partial privatization, which, according to comments of representatives of NJSC Naftogaz of Ukraine should be determined and approved by the supervisory board of PJSC UkrTransGaz, or NJSC Naftogaz of Ukraine itself. As a result of this alienation, a private proposition of storage services might be created, with the demand for such services expected to come from both local producers and domestic and gas export-import traders.

Encouraging the emergence of additional competition meets quite accurately the aims and purpose of the Directive, although some questions remain unclear as regards the adequacy of the powers vested in the supervisory boards of commercial companies to have disposal of strategic state assets privatized, as well as the time required for a thorough economic analysis of all the storage facilities that may be subject to privatization. Moreover, it is the competence of the State Property Fund of Ukraine to carry out privatization of the state property, not the commercial companies, which happen to operate such assets.

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THREATS 1
INCOMPLETELY UNFOLDED POTENTIAL OF ENERGY SECTOR REFORM.

The restructuring model proposed by NJSC Naftogaz of Ukraine indeed meets the purposes of liberalization as the newly-created transportation operator is going to be more independent. On the other hand, the Naftogaz group will retain a high concentration of various functions in the gas sector. Unwillingness to effect appropriate collateral changes in other gas businesses along with the transportation unbundling threatens to waste a valuable momentum for fundamental reforms.

Ukraine is required to carry out its reform in line with the best practices of Western countries, and do this as soon as possible. The Naftogaz reform is now part of the requirements of both European authorities and international financial organizations. These requirements are a major factor of pressure for government decision-making. Once the minimum requirements are formally met, a situation may emerge that in the absence of external pressure, the pace of further, much deeper reforms to weaken monopolies will slow down.

The presentation of Naftogaz devoted to the unbundling of the transportation business, as well as numerous comments by company executives, witness declared intention to further the reform of the energy giant through privatization and demolition of its vertical integration under certain circumstances in the future. But in the absence of proper objective stimuli, this strategy does not seem likely to be followed as this matter will fully depend on the free will of the company management in, tentatively, 2017.

Focusing only on the demand of separation of the GTS operator without other simultaneous steps for greater liberalization of related businesses may postpone the achievement of the actual objective of the energy sector reform, namely, the creation of competitive markets in the gas sector, which is currently exclusively occupied by one enormous state-owned company.

It should be noted in this connection that any privatization, the importance of which is emphasized in this paragraph, should be planned and implemented on the basis of thorough economic and legal analysis, a point with which NJSC Naftogaz of Ukraine agrees in its model, too.

THREATS 2
POTENTIAL BREACH OF THE 3EP DURING FURTHER PRIVATIZATION THROUGH THE SPFU.

If the SPFU owns corporate rights in the gas transportation operator, holding at the same time other state assets in the gas sector for privatization purposes, the requirements of both the Directive and the Law On the Natural Gas Market will be directly violated.

The key requirement and objective of the Directive in the “ownership unbundling” format is property-based division of the businesses providing transportation services from the contiguous activities of natural gas production and/or supply to consumers. Having chosen this model, which is also a priority model from the standpoint of European Commission practices, NJSC Naftogaz of Ukraine defines the State Property Fund the public body to manage the corporate rights of the proposed newly-created GTS operator. The company’s arguments generally narrow to the fact that under applicable law, the SPFU enjoys greater independence from the CMU.

At the same time, there is a general consensus among many stakeholders about the strategic intention to privatize many companies in the energy sector, in particular, PJSC UkrGazVydobuvannya. Whenever such state assets are sent to the State Property Fund, which is the central privatization authority, it will inevitably exercise simultaneous control over the GTS operator and such gas producers or gas supply companies, which is a direct and flagrant violation of the requirements of the Directive and the Natural Gas Market Law. The same considerations are applicable with respect to the power generating assets.

It should be noted that when discussing the process of liberalization in other European countries, an approach was voiced, according to which simultaneous control may be admitted if temporary and with some other circumstances in place. Such risks will not occur should any other body authorized to hold state-owned strategic assets but not involved in further privatization be used for the purposes of holding corporate rights in the GTS operator.

THREATS 3

A WORSE COORDINATION IN THE GTS-UGS SYSTEM AFTER THE OPERATIONAL RELATIONS HAVE BEEN CHANGED TO CONTRACTUAL. A SLOWER PROCESS OF ENFORCEMENT BY THE PARTIES.

Unbundling of the gas transportation operator from gas storage operator will mean transition to commercial contractual relations between them as two separate companies. This may potentially complicate and slow down the communication and coordination between them, especially in emergency situations.

A key component of the model of NJSC Naftogaz of Ukraine is formal, technical, and operational division of the existing gas transportation complex primarily between the newly-established GTS operator and PJSC UkrTransGaz as the gas storage operator. In developing this concept, Naftogaz refers to the World Bank consultants’ report.

Already at the first stage, the replacement of the operational links between the new gas transportation operator and PJSC UkrTransGaz as the storage operator will require some time to develop contractual grounds for cooperation and coordinated work of both systems. In the privatization period, the coordinated work of all elements of the gas transportation complex will require an even more complex system of contractual relations among a greater number of parties. It is important to emphasize however that state of the art operators’ network codes, as well as effective tools for their enforcement should be generally sufficient in order to secure harmonized cooperation of multiple parties.

Apart from the discussed difficulties, the departure from the operational model of relations under which the head of a single organization has the right to directly issue binding instructions to employees will create the risk of worse coordination, because the only way to enforce the contractual obligations between the GTS operator and the UGS operator remain recourse to a court.

Under emergency and contingency situations, especially during a heating season and those connected with the international transportation of natural gas to European consumers, such potential coordination complications may grow into a risk that needs to be accounted for already now.

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22 Analysis of the Restructuring Options of NJSC Naftogaz of Ukraine - Unbundling options for gas transmission and storage, February 2016
THREATS 4

COMPLETE LOSS OF INVESTMENT ATTRACTION FOR THE UGS.

The business model of PJSC UkrTransGaz as a gas storage operator deprived of profitable transit business, will lower the odds to attract a foreign investor and significantly narrow opportunities for the funding needed for modernizing and developing the UGS system of Ukraine.

Based on the financial results presented in the annual report of NJSC Naftogaz of Ukraine for 2014, natural gas storage business generates approximately UAH 3 billion in losses. The Naftogaz’s suggestion is that the most financially successful of the existing storage facilities be privatized after their thorough economic and technical analysis and on the basis of the strategy developed by the supervisory board(s) of UkrTransGaz and/or Naftogaz to consider the strategic role of such facilities and the reason to keep them in state ownership.23

Thus, while observing the strategic significance factor, the plans are to remain in the property structure of the Naftogaz group the most unprofitable UGS whose only funding sources would be either the internal cash flow of the still loss-making NJSC Naftogaz of Ukraine,24 or additional budget injections, or debt financing, probably, against government guarantees again. None of the above options can be considered satisfactory as neither of them meets the strategic goal of the company management to lead the state-owned giant out of its dependence on budgetary support and enable it to generate income by itself. This analyses is based on the data available in the consolidated financial reporting of the NJSC Naftogaz of Ukraine’s group of companies for 2014, and the figures of the following periods may change the described situation. Particularly important in this regard may be potentially increased demand for the gas storage services from the EU member-states, as well as value and capitalization of such assets immediately proxy to the EU eastern borders.

THREATS 5

RETENTION BY NAFTOGAZ OF INDIRECT CONTROL OVER THE GTS OPERATOR AS A RESULT OF ITS MANAGEMENT OF SPECIFIC UGS.

In circumstances of the national regulatory authority remaining weak or dependent, the control over the system of gas storage facilities may in practice mean indirect control over the gas transmission system operation regime. This appears especially important in view of some specifics of the operation of Ukraine’s system of trunk pipelines, which is characterized by cycles of injection and withdrawal of gas required for the heating seasons.

The existing functional model of Ukraine’s gas transportation complex requires coordinated and simultaneous control of the trunk pipelines and underground storage facilities. The technological process is so tight that, among other things, a separate study was necessary, conducted by specialists engaged by World Bank to establish the technical and operational possibility of their separation. The conclusion of this study generally established that UkrTransGaz operated the GTS and UGS facilities separately,25 and Naftogaz representatives confirmed that balancing the GTS without the UGS’ support could technically be possible for one

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23 Materials of NJSC Naftogaz of Ukraine to the roundtable meeting of February 19, 2016, slide 5.
24 According to the annual financial statement, the net loss of the NJSC in 2014 totaled UAH 77.6 billion.
The aforementioned report indicates, however, that the UGS play an important role in both satisfying the national needs and in the international gas transportation processes.

In any case, at least for some transitional period, the full functioning of the GTS will require close cooperation with the UGS operator that remains part of NJSC Naftogaz of Ukraine. Regardless of intentions and strategies of UkrTransGaz’s and Naftogaz’s management teams, the said control will persist for some time, which duration will largely depend on the willingness of PJSC UkrTransGaz to abandon such indirect control. Naftogaz’s position is that any possible control will be limited by the national regulator and, as such, does not pose any significant threat. At the same time, the level of decisive powers, performance quality, independence degree of the regulator is currently an open question since the reshaped National Energy and Utilities Regulatory Commission of Ukraine (NEURCU) is not only non-functioning, but even does not have a legal foundation. In such circumstances, the risk of preserving the vertical integration, albeit indirect, in the production, supply, storage, and transportation operations of the Naftogaz group remains real, thus undermining the meaning and essence of the reform and restructuring of this state giant.

The importance of the UGS function in the actual international transportation of natural gas is, unfortunately, not entirely clarified, which makes it difficult to fully assess the ability of the GTS operator to perform contractual obligations under transit agreements without involving gas storages. If gas storages are used at least as a safety net for the uninterrupted transit and especially if it represent a necessary and integral functional component of the transit process, control over the UGS system may theoretically enable the Naftogaz group to remain an indispensable player in international natural gas transportation.

**THREATS 6**

**HIGHER VULNERABILITY TO EXTERNAL INFLUENCES, INCLUDING THOSE FROM RUSSIA.**

The retention of the vertical integration of the numerous disparate gas businesses, with only natural gas transportation assets taken out, will leave Naftogaz the key player in the gas sector, and current and potential financial problems of some parts of the operations will mean the need for budgetary support for the entire group, as well as the pressure on any part of it will result in pressure on the entire energy sector of the country.

In the situation of standoff with the Russian Federation, which traditionally uses its energy resources as an instrument of pressure and influence in the region, the issue of strategic security should be receiving added attention. The interest of the Russians in Ukraine’s GTS is an established fact, and its key role for Russian gas supply to Europe even after the expiration of the current transit contract in 2019 receives constant support from the expert community. The dependence of different areas of Ukraine’s gas sector from the vertically-integrated Naftogaz and significant impact on the activities of the latter from possible direct or indirect (including through European intermediaries) trade cooperation with Gazprom reserves a special role to the NJSC Naftogaz of Ukraine as well as responsibility of its management for strategic security of energy supply. This

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26 According to the information provided by the company's representatives.

27 Supra note 25.

28 As of April 26, 2016, the relevant bill 2966-d was put to a vote in the Verkhovna Rada and passed in first reading.

also means that if Gazprom attempts to exercise pressure on gas production or supply, or storage services, it can do it through a single point of access, which already exists - the established ties with Naftogaz.

A more significant separation of different businesses and transfer of the assets that are currently under the control of Naftogaz, to various public or private entities may diversify this point of exposure and effectively reduce the risks associated with the aggressive business strategy of Gazprom and those arising from the possibility of personal bribery, blackmailing, or treason on the part of company management representatives. It should be noted that the cumulative effect of management of the group by the new management team gives no reason for looking for signs of this risk becoming real, but in selecting an optimum model of restructuring for the state giant, all associated risks should be taken into account.

THREATS 7

EMPLOYING OF SEPARATION OF THE GTS AND UGS AS A MEAN IN THE INFORMATIONAL WAR TO PROVE UNRELIABILITY OF THE UKRAINIAN TRANSIT ROUTE. NORD STREAM 2 FACTOR.

Against the backdrop of the traditionally no-so-high level of trust in the reliability of transit of Russian gas through Ukraine’s gas transportation system as a result of the military hostilities and arbitration proceedings, the change of the management system of the gas transportation complex with its operational and legal division among independent entities may add to the concerns of European consumers. This argument will undoubtedly be used in the information standoff between supporters and opponents of the Russian project Nord Stream II.

Currently, the business of Russian gas transportation to Europe is in a quite difficult situation due to numerous factors, including the falloff in prices and demand for natural gas due to moderate weather conditions and a decline in the European industrial output, emergence of non-traditional channels of supply to Europe, including through LNG terminals, and competing transportation facilities, both existing and projected. The raise in transit rates also causes a cumulative negative effect. In such circumstances, it seems reasonable to take every measure to strengthen the reputation of the operator of Ukraine’ GTS as a reliable partner, able to consistently and effectively provide the transit services, offering all the advantages of the complex available, including, if necessary, the buffer volumes of the underground gas storage facilities.

At the time when, the issue of the actual role of the storage facilities in ensuring uninterrupted international transit remains open, there are significant arguments in favor of the thesis that the possibility of instant use of the UGS is a significant advantage of Ukraine’s transit route. This does not exclude, however, the fact that this possibility can be of contractual nature, though, especially if the gas storage facilities contribute little to maintaining the normal mode of transit, the possibility of ad hoc (not contract-based) use of the UGS by the GTS operator in contingencies may be used as an additional argument in favor of further use of the Ukrainian transit route as opposed to such projects as Nord Stream II. Likewise, uncertainty as regards the availability of storage capacity and the need to develop models of cooperation of individual GTS and UGS operators may be used in proving that Ukraine is not reliable as a transit country. Thus, even regardless of the actual situation, the
separation of the GTS and UGS operators will serve as a convenient excuse for an information attack on the reputation of Ukraine’s transit potential.

**THREATS 8**

**POTENTIAL NEED TO CEDE THE TRANSIT AGREEMENT WITH THE RUSSIAN FEDERATION AND OTHER EFFECTIVE AGREEMENTS TO A NEW GTS OPERATOR.**

According to the information available as of 2009, the international transit of Russian gas is conducted under the contract of December 19, 2009 entered into between NJSC Naftogaz of Ukraine and PJSC Gazprom; the technical performer of the obligations of Ukraine as contracting party is named AE UkrTransGaz whose legal successor is PJSC UkrTransGaz. Although this contract does not prohibit in principle the rights and obligations to be assigned to a third party, such as the newly-established GTS operator, the practical implementation of respective actions may encounter significant difficulties.

Taking into account the possible changes to the transit contract terms published immediately after its signing, which may significantly affect the general conclusions, there may be a few options for transferring the functions currently performed by UkrTransGaz to the newly-created GTS operator, each of which, however, will require the express consent of Gazprom. These are the assignment of the entire contract or replacement of UkrTransGaz as the company responsible for the technical implementation of Naftogaz’s obligations under the contract. It can be reasonably expected that Gazprom, acting in line with the general political strategy of the Russian Federation, will be undermining all and any efforts of Ukraine aimed at approximation with the EU and will therefore not agree to the relevant proposals of its own free will.

Apart from this, there exists a possibility of unilateral change of party through corporate transformation of NJSC Naftogaz of Ukraine, resulting in the rights and obligations under the transit contract assigned to the newly-created entity, but practical implementation of this possibility requires a dedicated legal analysis. Thus, proceeding solely from the available public domain information, it may be concluded that the transfer the GTS assets to the newly-established company outside the Naftogaz group will likely produce more serious legal consequences (this is likely to be completely impossible without the consent of Gazprom), than separating of the technical performer of the contractual obligations without changing such performer’s legal capacity.

According to the information in hand, a right to unilaterally change the party under such a contract is, inter alia, a claim of Ukraine in the ongoing arbitral litigation between Naftogaz and Gazprom, which in the case of winning would render this factor irrelative. In a broader sense, all effective agreements and contracts of UkrTransGaz, both concluded with Ukrainian enterprises and organizations and internationally, other than the above-mentioned contract between Naftogaz and Gazprom, will be subject to the procedures of assignment (or termination and further conclusion of new ones) in favor of MGU, which, given the absence legal ways to automate this process, may become a lengthy and complex process.

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32 May be only possible subject to the written consent of Gazprom, Article 13.8 of the transit contract.
33 May be possible by accordingly amending Article 4.6 of the transit contract, subject to the mutual consent of the parties.
34 Article 13.5 of the transit contract.
MODEL SUGGESTED BY THE MINISTRY OF ENERGY AND COAL INDUSTRY

STRENGTHS 1

NO VERTICAL INTEGRATION, WHICH BETTER MEETS THE 3EP REQUIREMENTS AND REDUCES REGULATION IN NAFTOGAZ.

The proposal of the Ministry of Energy envisages complete separation of gas transmission and distribution businesses from production and supply activities. Thus, the Naftogaz group completely abandons its vertical integration in the meaning of the Directive, which is the purpose of liberalization in its essence. Apart from better compliance with the spirit of the Directive, the absence of the vertical integration will release Naftogaz and the government of the need to develop and introduce additional measures to ensure independence for the UGS operator from other businesses of the group.

Both theoretical admissibility the ISO and ITO models and respective admissibility of preserving the vertical integration of the storage and production/supply functions were a compromise reached by the EU authorities with national governments when negotiating approaches to liberalization. Therefore, considering Clauses 6, 13, and 25 of the Directive, the vertical integration is not desirable for market openness and may exist only if numerous internal unit separation procedures are adopted.

Thus, the combination of the ownership unbundling model and elimination NJSC Naftogaz of Ukraine’s status of a vertically-integrated gas undertaking is the most desirable approach in terms of liberalization results. Under any other model that leaves direct or indirect control over the UGS operator to the Naftogaz group this control must inevitably be limited by a complex system of internal procedures and rules, as well as additional acts of secondary legislation, which all is not required in the approach proposed by the Ministry of Energy and Coal Industry.

STRENGTHS 2

GREATER FINANCIAL TRANSPARENCY OF BUDGETARY SUBSIDIES

If the vertical integration of NJSC Naftogaz of Ukraine remains intact and considering the past experience, there exists a potential threat of non-transparency in using budget funding.

One example is failure of NJSC Naftogaz of Ukraine to include the cost of the gas transportation services (UAH 305.6 per 1,000 m³) Naftogaz Ukraine in the price for gas used to produce heat for households when calculating the amount to offset the difference in prices in 2012. As a result, the price for the gas sold

36 Directive 2009/73/EC Article 15; Gas Market Law Article 47
to business entities for these purposes was understated. That, accordingly, allowed the compensation amount to be overstated by UAH 583,165,000, an additional burden on the state budget. The amount of UAH 3.9 billion allocated from the state budget as compensation for the difference between the purchase prices of imported natural gas and its selling prices for business entities to generate heat for the households failed to improve the efficiency of NJSC Naftogaz of Ukraine and balance its financial situation. Starting from 2012, a trend of financial degradation began firming up in the company. By the end of 2014, losses of NJSC Naftogaz of Ukraine totaled UAH 88.4 billion.

*Not just transportation function unbundling, but separation of Naftogaz into stand along independent companies would prevent such practices in the future.*

**STRENGTHS 3**

**NO NEED TO CHANGE THE EXISTING TECHNICAL MAINTENANCE SYSTEM**

In fact, if the structure of PJSC UkrTransGaz remains unchanged, there is no need to create a new infrastructure maintenance company or switch to contractual relations if these functions are delegated to another company.

Unlike the model proposed by NJSC Naftogaz of Ukraine, the model of the Ministry of Energy and Coal Industry does not require that the maintenance system be removed from the internal structure of the gas transportation complex. If the maintenance functions are separated, the GTS operator may refuse to secure maintenance from the existing unit and choose another one, including respective European companies, on a competitive basis, thereby making the existing maintenance unit to shut down. If the existing combination of the GTS and UGS operators, represented by UkrTransGaz, remains intact, the maintenance unit will keep servicing all facilities without distinction and will not be forced to undergo internal evaluation and restructuring to separate the specialists covering exclusively trunk pipelines from other units. Additional effort in this respect will be required in order to prepare certain gas storage facilities for privatization in the future. Such internal audit of the maintenance department would probably generally optimize the staff and, subject to sufficient political motivation, also result in organizational and functional modernization. However, if not required, it will not hamper the readiness of the service preserved combined to carry on immediately.

**STRENGTHS 4**

**POSSIBILITY TO DEVELOP A HARMONIZED DEVELOPMENT STRATEGY FOR THE GTS WITH STRATEGICALLY IMPORTANT UGSS AS AN INTEGRATED COMPLEX.**

According to the World Bank report, the integration between transit and domestic use of the GTS and UGS is an important aspect of the complex use of the system, which will have significant implications in the future, too.

Thus, a combined system of gas pipelines and those storage facilities necessary for the network to operate substantially enhances the reliability of the gas transportation complex and guarantees uninter-
rupted supply of gas for domestic consumption and its transit to countries of Europe, which also allows for balancing the prices in volatility periods. **In fact, by not splitting the development strategies of the GTS and strategically important UGS apart and by developing shared modernization stages for both systems, the state secures the possibility of synchronized gas transportation and storage operation and reconciles throughput capacities of both systems.** Moreover, a combined maintenance department will help avoiding equipment-related conflicts and have a coordinated maintenance operation. For example, the European Commission sets as the chief objective of its draft strategy for LNG and gas storages the development of infrastructure - receiving LNG terminals and gas pipelines - to ensure that each EU country has either direct access to LNG or indirect, the one based on gas hubs whose prices are influenced by LNG supply. Gas storages should play a balancing role with increased LNG supply to Europe to make the delivery of regasified LNG further inland technically and economically feasible. Brussels proposes that local regulators revise some exceptions to the Third Energy Package (granted to many LNG terminals) to increase their operational load.  

The World Bank consultants’ report clearly emphasizes the importance of gas storages in natural gas transportation from the eastern border to Europe and suggests two best options for unbundling of the UGS:  

The UGS operator is fully independent;  

The holding company owns the GTS and UGS: while the core UGS activities are separated.  

It should be noted that in both cases the report points to threats of non-transparent and discriminatory use of storage facilities if the storage function remains with Naftogaz due to its close connection with the production and supply functions.  

**STRENGTHS 5**

**QUALITY STRATEGIC PLANNING OF THE MINISTRY OF ENERGY AND COAL INDUSTRY OF UKRAINE, CONSIDERING NETWORK DEVELOPMENT OPTIONS PROPOSED BY THE INDEPENDENT SUPERVISORY BOARD OF UTG.**

Ukraine’s gas transportation market requires a common logic understandable for potential investors and market players. The proposals of the Ministry of Energy and Coal Industry of Ukraine call for a strategic vision on the development of the gas sector and energy branch as a whole. The OECD Guidelines on Corporate Governance of State-Owned Enterprises, among other things, provide that the state should act as an informed and active owner managing the company highly professionally and effectively, and at the same time, cautions that the management bodies of companies in state ownership should be granted a high degree of decision-making independence. At the movement, there is no reliable information regarding the nature and timing of the corporate governance reform of UkrTransGaz, nor about any details of plans for such a system to be developed for PJSC MGU planned to be existing in

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41 World Bank, 2016. Ukraine Gas: Unbundling options for transmission and storage, p. 6  
42 OECD (2015), OECD Guidelines on Corporate Governance of State-Owned Enterprises, Principle II  
43 The CMU failed to pass a decision on the PJSC UkrTransGaz reform at the time of its adoption of the decision on NJSC Naftogaz of Ukraine when approving CMU Resolution No. 1002 “Certain Issues Related to Improving Corporate Governance of the public joint-stock company National Joint-Stock Company Naftogaz of Ukraine,” dated of December 5, 2015
the ownership of the SPFU as proposed by Naftogaz. However, the ability of the Ministry of Energy and Coal Industry to make quality strategic decisions in assisting the independent management of the GTS operator in its strategy development and to provide competent advice when necessary to its supervisory board after the reform is a significant advantage which the SPFU does not have. In addition, the MECIU points out that it has the technical capacity and necessary knowledge to evaluate the development and modernization strategy for the gas transportation networks and storage facilities.\(^4^4\)

### STRENGTHS 6

**NO NEED FOR A COMPLICATED TECHNICAL AND OPERATIONAL PROCESS OF SEPARATING THE GTS AND UGS. SIMPLICITY OF PRACTICAL IMPLEMENTATION THE MODEL AND THREAT OF SPONTANEOUS SEPARATION.**

The separation of natural gas transportation and storage functions in Ukraine might be a difficult and lengthy process, which compares poorly in terms of implementation with the model proposed by the Ministry of Energy and Coal Industry.

The historic combination of natural gas transportation and storage in a single interconnected network developed close economic, operational, and technical ties between the two. Despite the assertion of NJSC Naftogaz of Ukraine that the connection between the GTS and UGS is rather virtual, the latest statements of PJSC UkrTransGaz on the term of three years needed to actually have the systems split implies otherwise. "The separation of our UGS and transportation facilities - it is not that easy to divide the company: it is balanced and works as single team. When we spoke with the World Bank, we agreed that this project would take up to three years," said Ihor Prokopiv, the Head of UkrTransGaz\(^4^5\). Thus, if the GTS and UGS remain within the single structure of PJSC UkrTransGaz, no issue of complex separation process will be coming up. This point is also confirmed by the World Bank experts who stressed the key role of the underground gas storage facilities.\(^4^6\)

An important argument in favor of the Ministry of Energy and Coal Industry’s model is its simplicity in practical implementation, as the separation of gas transportation and storage requires considerable time which Ukraine does not have, as well as substantial reformatting of the existing system of governance and, accordingly, fewer legislative changes.\(^4^7\) Yet another argument in support of this model is that the GTS-UGS separation should be preceded by an inspection of the facilities and technical evaluation of such steps. Ukraine does not have time for such procedures, while a spontaneous separation may be dangerous. Along with that, it is expert view that based on the European countries’ experience, the new TSO would in any case be substantially formed by UTG departments, and therefore it is not practicable to completely get rid of the “institutional memory”.

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\(^4^6\) Analysis of the Restructuring Options of NJSC Naftogaz of Ukraine - Unbundling options for gas transmission and storage, February 2016, slide 88.

\(^4^7\) World Bank Letter No. 2015/12/01-1, dated December 1, 2015
WEAKNESSES 1

PROBABLE RETENTION OF THE UTG MANAGEMENT AND STAFF, REPUTATIONAL RISKS.

The formal transfer of PJSC UkrTransGaz under the control of the Ministry of Energy and Coal Industry makes it highly likely that the old management team and, accordingly, the old methods of work will remain intact, which will not improve the company’s operation and will not make the management more transparent.48

One example of the management problems in the company’s past is the criminal proceedings against PJSC UkrTransGaz for laundering UAH 51 million, when the company’s management arbitrarily increased the value of an object of procurement, namely the services of installation, maintenance, and repair of broadcasting and retransmission equipment.49 Another example is the allegations by the Prosecutor General’s Office charging Naftogaz and UkrTransGaz officials of transferring UAH 400 million of public money to the accounts of fictitious companies.50 These facts are an indication of the risk of recurrence of such violations should the part of the management team engaged in these activities remain. Therefore, the management of PJSC UkrTransGaz should comply with the European management standards and have an impeccable reputation.

Restoration of trust in the company on the part of European investors and market players should not be expected without changes in the quality of management system.

WEAKNESSES 2

UNCLEAR REDISTRIBUTION OF ACCOUNTS RECEIVABLE AND PAYABLE.

If PJSC UkrTransGaz splits from NJSC Naftogaz of Ukraine, potential difficulties are likely to arise in redistributing the accounts receivable and payable.

First, a situation may occur when this move will be required to be agreed with a third party, and if the latter disagrees, this redistribution may not be possible at all or would result in technical defaults of the debtors.

Third party claims (including those from NJSC Naftogaz of Ukraine) against PJSC UkrTransGaz total approximately 19-20 billion m³ of natural gas.51 It is unclear how PJSC UkrTransGaz will be clearing its debts, considering that its functions will not include accumulation of gas reserves by itself, as well as its marketing.

WEAKNESSES 3

SIGNIFICANT TIME FOR ESTABLISHING A SYSTEM OF COMMERCIAL CONNECTIONS INSTEAD OF OPERATIONAL.

If the production and trading operations are separated, the operational ties will be broken and will need to be replaced with commercial ones, which will take time and legal formalities. The establishment of new commercial relationships may result in changed terms and conditions of new agreements, affecting the end user.

48 Analysis of the Restructuring Options of NJSC Naftogaz of Ukraine - Unbundling options for gas transmission and storage, February 2016, slide 19.
Thus, rapid separation would lead to the existing operational ties are broken, and PJSC UkrGasVydobuvannya will need significant additional time to establish cooperation again. It should be noted that recently NJSC Naftogaz of Ukraine has not taken any dividends accrued from UGV, directing this money to developing this production company. Also, according to the CMU resolution on special duties, UGV is bound to sell all gas it produces to NJSC Naftogaz of Ukraine until April 1, 2017.52

In addition, UGV management stated on multiple occasions that the direct subordination to the Government is not desirable and that a medium of a parent company would thus be expedient for the company.

WEAKNESSES 4

LESSER COMMERCIAL APPEAL OF THE GTS WITH UGS AS PURELY BUSINESS ASSETS (BASED ON THE FINANCIAL STATEMENTS OF NJSC NAFTOGAZ OF UKRAINE)

Considering that the UGS are unprofitable, capacious, and having non-transparent tariff setting procedure, the GTS appears, if assessed from purely commercial and return capacity standpoint, more attractive if not combined with the GTS.

Gas storage in Ukraine and Europe is currently a loss-making business (the results of 2014 showed that the natural gas storage segment was at a loss of UAH 2.9 billion)53. Therefore, it may draw down the real value of the GTS if sold in package. According to the views of independent experts, the tariffs for injection in, storage at and withdrawal from the UGS are been kept low artificially. In addition, Ukraine does not have transparent and understandable natural gas storage tariffs setting procedure, a fact discouraging investments in this segment. Furthermore, Ukraine’s UGS need to be overhauled for further modernization to reduce storage costs and enhance investment attractiveness. Gas balancing via storage and other strategic importance of the UGS should be taking into consideration as well.

OPPORTUNITIES 1

STRATEGIC IMPORTANCE OF THE GTS AND SPECIFIC UGSS FOR THE PURPOSES OF TRANSPORTATION TO THE EU BORDERS.

There are many factors indicating that a combined technical complex of GTS and at least separate UGSS creates additional advantages as regards the international gas transportation westward. Combination of the GTS and UGS operators in a single legal entity is thus likely to increase its overall investment attractiveness, especially for the European investor.

If the gas offtake by EU countries spikes unexpectedly, the extra amount of natural gas intended for these purposes can be compensated for on the eastern borders from the specific UGSs. If the UGSs are put in use, the fluctuations in gas offtake volumes can be balanced within 3 to 4 hours, otherwise 36 hours will be required to transport gas from the eastern border to western gas metering stations. In other words, the UGS

52 CMU Resolution No. 758 October 1, 2015 introduced a price ceiling for gas sold to households, effectively limiting the pricing for the gas produced by UGV and marketed through Naftogaz until April 2017.

53 Consolidated financial statements of NJSC Naftogaz of Ukraine as of December 31, 2014 and for the year that ended on that date.
may compensate for a decrease in GTS throughout capacity resulting from emergency works or force ma-jeure. Storage facilities also help balance the seasonal and peak fluctuations in natural gas consumption.54 The model proposed by the Ministry of Energy and Coal Industry of Ukraine provides for a unified system of gas storage and transportation, which will guarantee a better operational coordination between the GTS and UGS. It is also necessary to take into account that the UGS play a balancing role in gas transportation,55 and allow suppliers to put in reserve gas purchased at lower prices to address the needs for the heating seasons. Among other things, it guarantees investors supply continuity in the event of force majeure repeatedly provoked by Gazprom (the stoppage of gas supply to Ukraine on November 25, 2015, creation of an ad hoc team to prepare to suspension of gas supply to Ukraine in January 1, 2008, etc.).

In this context, the European think tanks (the Hague Centre for Strategic Studies, Brussels Centre for European Policy Studies) defined the terms directly addressing Ukraine’ energy security and its participation in the European energy sector. According to them, the gas conflicts between Ukraine and Russia are long-term and create systemic risks for the EU for years to come. At the moment, the European UGS capacity totals approximately 100 bn. m³. According to European experts, a storage volume of 140 bn. m³ is the amount required to satisfy the European consumption market in case of supply stoppages or suspension on the part of Gazprom. Europe needs to spend about EUR 20 billion to construct new storage facilities to reach the required storage capacity. However, the storage capacity currently available in Ukraine can partially solve this problem, if Ukraine’s UGS are modernized and their infrastructure improved. It should be noted that since December 3, 2014, Rule N-1 has been in effect in the European Union, according to which a member state that depends on one and only pipeline or one and only underground storage facility is obligated to secure for gas demand in extremely cold days in full, even if the supply is stopped completely.56 It should also be noted that if natural gas storage and transportation operations are separate, the gas price for the end consumer will be greater due to the introduced commercial margin for storage.

OPPORTUNITIES 2

GUARANTEED INVESTMENTS IN MODERNIZATION OF THE UGS ALONG WITH THE GTS

Given the greater investment attractiveness of the GTS as compared to the UGS (an investment in the GTS will return much earlier), by combining these two functions it is safe reckon to receive investments both in transportation and in storage.

The single technical complex, if retained, makes it possible to synchronize modernization of the GTS and UGS, and to elaborate a common development strategy to reconcile gas transmission and storage capacities. This complies with the provisions on the GTS Partner (Article 21) and UGS Partner (Article 45) in the Gas Market Law.

At the same time, the introduction of new storage technologies will reduce gas losses in the storages, improving their energy efficiency. For example, according to Gerhard König, head of the gas transportation company Wingas, Austria has ensured its energy security during the transit crisis of 2009 solely due to its

55 Analysis of the Restructuring Options of NJSC Naftogaz of Ukraine - Unbundling options for gas transmission and storage, February 2016, slide 88.
own UGS capacities.\textsuperscript{57} That was the reason for Austria to start expanding its existing storage capacities in 2009. Also, Poland opened an LNG terminal in 2015. The terminal is designed to receive 5 bn. m\textsuperscript{3} of gas a year, and will help develop the gas transportation infrastructure to supply part of the gas delivered by tankers to neighboring countries, including Ukraine.

OPPORTUNITIES 3

ADVANTAGES OF A COMPETITIVE PRODUCTION MARKET (CHOICE FOR END USERS).

After the expiration of the CMU resolution that binds UkrGazVydobuvannya to sell gas produced to NJSC Naftogaz of Ukraine at a specific and rather low price, UGV may have a chance to become a fully functional player on a competitive market should it be able to sell its gas to various competing suppliers. The model proposed by the Ministry allows to get sooner at that point.

A competitive natural gas production market will, in the first place, provide the end user with an opportunity to choose the best price from those offered on the market. It will also send a positive signal to international investors with a promise of good prospects for investment in a market free of state monopolies and developing under clear and transparent rules. In turn, the growing investment will make it possible to build new capacities and upgrade the existing ones, increasing the domestic gas output and reducing Ukraine’s dependence on imports. Specifically, according to NJSC Naftogaz of Ukraine\textsuperscript{58}, 17.2 bn. m\textsuperscript{3} gas produced in Ukraine was used to satisfy the needs of households as compared to overall amount of 19.5 bn. m\textsuperscript{3} of produced gas, of which 73 percent was accounted for by UkrGazVydobuvannya. Therefore a competitive market, when created, will allow other players to expand their capacities and end users to choose the most reasonable price.

OPPORTUNITIES 4

BETTER ELABORATION OF STRATEGIC PLANNING BY TAKING ACCOUNT OF ELECTRICITY, GAS AND OIL IN TRANSPORTATION COMPLEX

In line with Directive 2009/73/EC, para. 11 \textit{“In view of the vertical links between the electricity and gas sectors, the unbundling provisions should apply across the two sectors”}. The model by the Ministry is more thought-trough and structured in this regard as long as it contemplates unbundling not just in gas market, but also in power industry, and also secures possible future violations in terms of control.

To the opposite, Naftogaz’s model tends to narrowly focus on the gas industry, which creates risks not just in terms of violation of the Directive prescriptions with regard to the temporary non-compliance by the State Property Fund of Ukraine’s simultaneous control over production and transportation assets while privatizing, but also in terms of similar problems with power generating assets. It is accordingly not provided by the Naftogaz’s model which authority should be in control over the power transportation assets and how

\textsuperscript{57} A. Hurkov “UGS Haidach: Gazprom Gas under Alpine Meadows” // DW - May 26, 2011.
that will be fitted with the requirements of the Directive. It is important since a foreign investor would be primarily seeking for understandable rules of the market functioning and confidence in its transparency, which would secure its control over the investment on every stage of value chain in line with the best European practices.

*The Ministry suggests a comprehensive approach to the reforming of the energy industry by distancing the incompatible assets under different verticals of executive authority and securing the ability of SPFU to run privatization process without violating the laws.*

## THREATS 1

**SIGNIFICANT POLITICAL RISKS OF INFLUENCE OF THE MINISTRY OF ENERGY AND COAL INDUSTRY ON THE NETWORKS AND STORAGES.**

Under this reorganization scheme, the Ministry of Energy and Coal Industry retains full control over gas transportation and storage assets in Ukraine, which entails significant political risks.

The Ministry lobbying the interests of certain stakeholders will inevitably distort competition on the market due to unequal network access. Therefore, without secondary legislation that will protect the GTS and UGS from possible direct interference in their business activities, the immediate subordination to the Ministry of Energy and Coal Industry may be dangerous. In fact, the Ministry itself recognizes this risk: “Thus, *if an improved regulatory framework is in place, featuring a clear and reasonable balance between the management functions of the Ministry of Energy and Coal Industry (as a shareholder of PJSC UkrTransGaz) and independence of PJSC UkrTransGaz in its usual course of business*”.

This means that without a secondary legislation that will safeguard the relationship between the Ministry and UkrTransGaz against possible abuses, this concentration of assets poses significant threats. This is also consistent with the OECD principles of corporate governance of state-owned enterprises, which recommends as broad scope of independence for state bodies as possible.

## THREATS 2

**MISSED CHANCE TO CREATE A COMPETITIVE MARKET OF STORAGE IN THE SHORT TERM**

According to the document published by the Ministry of Energy, no partial or complete privatization of the UGS should be expected in the short term, which effectively freezes the chances for a competitive gas storage market to emerge in the near future.

On the one hand, the UGS in state ownership enable equal access for market players, but on the other hand, the lack of competition on the market hinders the development and modernization of the existing facilities. Also, the absence of privatization prospects for the gas storage branch delays introduction of market-based pricing for storage tariffs, which will negatively affect the investment prospects of the UGS. The foreign investor is not motivated in investing in an overly regulated market segment.

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59 Analysis of the Restructuring Options of NJSC Naftogaz of Ukraine - Unbundling options for gas transmission and storage, February 2016, slide 88.

In their report, the World Bank consultants highlighted the need for pricing transparency, accessibility of information and accessibility of the existing storage facilities and associated transportation and cross-border transfer facilities in order to enhance the investment attractiveness of natural gas storage in Ukraine. However, as they estimated, of Ukraine’s gas storages of 31 bn. m³ capacity, only facilities totaling a 7 bn. m³ storage capacity feature a relatively high offtake performance, which makes them potentially attractive as a trading asset\textsuperscript{61}.

**THREATS 3**

**CRUDITY OF THE STATE HOLDING CONCEPT, NO PRIVATIZATION STRATEGY FOR UGV**

The model proposed by the Ministry of Energy and Coal Industry suggests transferring of petroleum production and processing assets to a newly created state holding company, but there is no concept of its functioning, nor details of its legal foundations.

This presents significant threats, as long as fails to provide transparency and possibility of public evaluation of the company model, and also there remains a risk of its non-compliance with European standards and potential abuses on the gas production market. There are also no privatization principles and schedule developed for UGV, which seriously delays introducing of competition on the gas producing market. In addition, the relationship between the State Holding company and NJSC Naftogaz of Ukraine as the major trader on the gas market and supplier of last resort is yet to be described. Another deficiency is the fact that there is also no secondary legislation in place to regulate the state holding company and its relations with other market participants. *Considering the scale of the future holding, the lack of understanding of even the basic principles of its operation bears significant systemic risks for both market participants and investors.* The model also fails to include a privatization strategy for UkrGazVyдобування that after April 1, 2017 will no longer be bound to sell all gas it produces to NJSC Naftogaz of Ukraine, according to the Cabinet of Ministers’ special duties resolution.

**THREATS 4**

**DIFFICULTY FOR UGV TO OPERATE UNDER IMMEDIATE CONTROL BY THE GOVERNMENT**

The restructuring model proposed by the Ministry of Energy and Coal Industry provides, in particular, separation of the production branch, which is to be transferred to the jurisdiction of the proposed State Holding company, from the trading activities that remain with Naftogaz. This would probably result in UkrGazVyдобування not having an effective intermediary in its subordination to the Ministry of Economy and short in its other external functions, which are currently performed by Naftogaz.

If oil and gas production business are separated and transformed into separate relatively independent arms of the State Holding, an urgent need emerges to create a number of organizational units that will fulfill

\textsuperscript{61} “World Bank, 2016. Ukraine Gas: Unbundling options for transmission and storage, p. 6”
those external functions currently performed Naftogaz, specifically, to market produced and processed products.

This will take some time to establish commercial relationships and recruit qualified staff. Apart from the fact that this process is lengthy, the performance of re-subordinated companies is likely to decline for the time of some transitional period, and the overall negotiating position of individual companies when establishing new contractual terms of operation with counterparties may be weaker than that of the centralized and mighty NJSC Naftogaz of Ukraine. A positive factor here will be a better preparedness of the companies for possible future privatization, although the alternative restructuring model quite reasonably leaves some time for such processes, which, as it currently appears, will not be the case with the hasty transfer of the assets to the state holding.

In addition, specific steps and stages of the said process largely depend on the legal nature and functional character of the proposed State Holding, as well as the degree of independence of the supervisory board of the companies under its control. It should be noted that the development status of the holding concept could be currently described as visionary or theoretical. Therefore, it is rather difficult to assess the complexity of the problem, although the very fact of no clarity in the plan of the Ministry of Energy and Coal Industry implies that the finalization and implementation of this concept will require quite a considerable amount of additional time.