German Advisory Group Ukraine

NEWSLETTER

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Ukrainian gas sector: A window of opportunity not to be missed

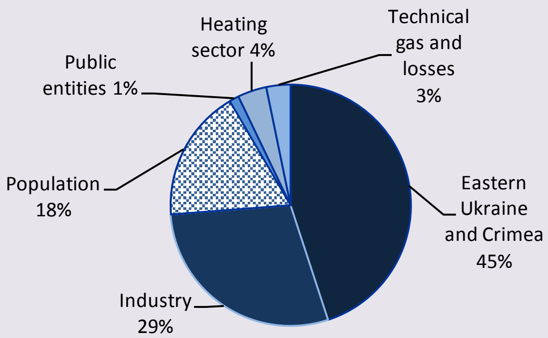
Since 2013, the Ukrainian gas sector has been experiencing a transition process at high speed. Due to the economic and political crisis, gas demand plummeted. Gas imports from Russia have decreased by about 75% since 2013. Simultaneously, Ukraine has started to import gas from Western partners. Low gas import volumes in combination with lower gas prices nearly halved the expenditures for gas imports, thus significantly contributing to the macroeconomic stabilisation of the country.

The drop in international energy prices, the contraction of domestic gas demand, excess supply in the European gas market as well as technical and financial support by the EU provided Ukraine with significant and unprecedented room for manoeuver regarding the implementation of far reaching reforms in the gas sector. Ukraine must quickly use this room for manoeuver, as these favourable economic conditions will not last forever.

Contraction of domestic demand

The massive slump in domestic gas demand is the major development for the Ukrainian gas sector. Domestic gas consumption has declined by one third between 2013 (50 bcm) and 2015 (34 bcm). The conflict in Eastern Ukraine and the annexation of Crimea is the main reason for this decline in domestic demand, since the affected areas used to account for 15% of the total Ukrainian gas consumption. The second reason for the general slump in energy demand has been the sharp recession. Industrial production has declined by 27% between 2013 and 2015, leading to a 44% decline in industrial gas demand. Moreover, the gas transit through and within Ukraine have decreased significantly. Consequently, there has been a decline in the technical gas required. Finally, the increase in gas tariffs caused a decline in gas demand among the population as did the saving efforts of the Ukrainian government.

Composition of reduction in gas demand

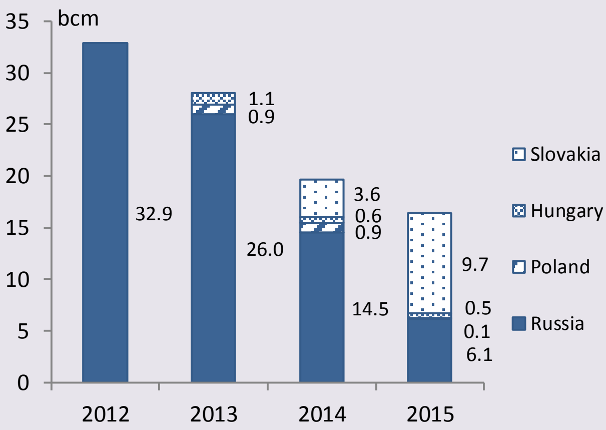


Source: Own estimations

Structure of gas imports

As the contraction in gas demand occurred under a nearly stable gas production, Ukraine was able to reduce its gas imports from 28 bcm to 17 bcm. Concurrently, it quintupled its gas imports from Western countries, previously amounting to 2 bcm, to 10 bcm, allowing Ukraine to significantly reduce its gas imports from Russia. Exploiting the full import capacity from the Western countries (22 bcm) even allows Ukraine to fully renounce any Russian gas imports. Thus, over the first quarter of 2016 there were no gas supplies from Russia. Admittedly, this strategy requires to start injecting gas into the storages for the winter already in spring. Correspondingly, this also requires considerable pre-financing for the gas, which will only be demanded by the following winter. Due to the strained financial position of Ukraine, the European Bank for Reconstruction and Development (EBRD) has granted a revolving credit line of EUR 300 m to cover the needed pre-financing.

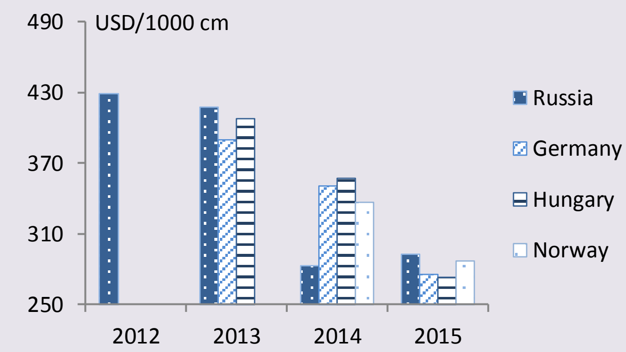
Gas import flows by country



Source: Naftogaz; Energobusiness

Besides the reduction in domestic gas demand, the excess supply in the European gas market was a major factor allowing Ukraine to renounce Russian gas supplies. The European markets were flooded with gas volumes, which are obtained in long-term contracts, beyond the demanded amount. Due to the resulting excess supply, European gas exporting companies were searching for new customers. By these means, Ukraine was benefiting from increased competition in the gas market (lowering prices) and was able to shift its gas supply sources to the West, reducing the dependence on Russia as (former) gas supply monopolist. Hence, expenditures for gas imports more than halved between 2013 and 2015, falling from USD 11 bn to USD 4.5 bn.

Gas import prices by country of supply



Source: Ukrstat

Transit of gas

Ukraine still provides the major transit route for Russian gas exports to Europe. Although Gazprom significantly diversified its transit routes in 2015 compared to past years, still 39% of a total of 119 bcm of Russian gas destined to Central and Western Europe were transported through Ukraine while 30% passed through Belarus and the Baltic Sea, respectively. Thus, after a slump in the beginning of 2015 (Jan/Feb 2015: 3.9 bcm) the Ukrainian transit volume had significantly recovered by the beginning of 2016 (Jan/Feb 2016: 8.3 bcm).

The planned construction of two more pipeline strands of the Baltic Sea pipeline *Nord Stream* providing an additional transit capacity of 55 bcm would enable Gazprom to fully exclude Ukraine as a transit route. This in turn could possibly cause a significant reduction in transit revenues, which previously amounted to USD 2 bn per year, and could also make gas supplies from Western countries to Ukraine more difficult and costly.

Energy policy

Through the IMF programme, the membership in the European Energy Community and the Association Agreement with the EU, Ukraine has pledged itself to far reaching, structural reforms in the gas sector. In this course, the massive rise in gas tariffs was a key step. By the end of April another rise in these gas tariffs was implemented, so that private households now face gas tariffs that have increased six fold since early 2014 from 1,048 UAH/tcm to 6,870 UAH/tcm. On the one hand, this increase in tariffs certainly helped to stabilise the financial situation of the state-owned gas monopoly Naftogaz and thereby positively contributed to the stabilisation of the state budget. On the other hand, it obviously contributed to the contraction of domestic gas demand and triggered incentives for long-term oriented efficiency enhancing investments.

The new legislation in the gas sector and the reform of the administrative structure of Naftogaz created solid ground for a transition of the Ukrainian gas sector towards a market economy sector. Nevertheless, in this process the "point-of-no-return" has not been reached yet and there is a possible threat that interest groups might block essential reforms such as the independence of the regulatory authority or the restructuring of Naftogaz.

Conclusion

In the past year, several exogenous factors have allowed Ukraine to continuously reduce the so far critical dependence on Russian gas imports. These developments created significant room for manoeuver regarding the reform of its gas sector. However, these favourable factors (low international energy prices, reduced domestic demand, and excess gas supply in the European market) will not last forever. The construction of *Nord Stream II* could hamper the gas supplies from the West. In that case, Ukraine would again become dependent on gas supplies from Gazprom. Therefore, Ukraine needs to finalise and institutionally anchor the structural reforms, which it has already initiated, in order to provide credible framework conditions for further investments and for the transit of gas through its territory.

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Note: A more comprehensive analysis of the topic is provided by the Technical Note TN/01/2016 "Ukraine energy update 2015/16"

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German Advisory Group

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