

Changes on the Ukrainian gas market

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On 16 July, President Viktor Yanukovych signed into law a bill concerning Ukraine's gas market, which formally accords with EU directives concerning how the functions of business entities operating on that market will be divided up, as well as the liberalisation of the gas market itself. On 13 July, a decision to raise gas prices was also announced, which is the first step in bringing prices for the general public and the heating sector closer to market values. At the same time, however, other clauses in the bill, concerning the level of dependency of the gas-related entities and the participation of the state in the direct regulation of the market, mean that the adopted solutions can be seen as only a first step in the direction of liberalising the gas market.

The above-mentioned actions are the first example of the serious economic reforms which have been expected from the new government of Ukraine. They were taken under the influence of the EU (the law concerning the gas market), and under pressure from the IMF (raising gas prices). Whether they have any real influence on the economy will depend on whether they prove to be a path to genuinely liberalising the gas market and introducing market prices onto it. At the current stage, though, Kyiv's decisions pose no threat to Gazprom's interests in the Ukrainian gas sector.

The law of regulations on how the gas market will function

The new law of 8 July 2010, promulgated by the president, establishes the free choice of distributor and supplier by customers, the free access of gas-related entities to the pipeline system and underground gas holders in Ukraine, and at same time obliges operators to make the infrastructure available to all interested parties under the same conditions. In accordance with the directive 2003/55/EU, a strict specialisation of these entities has been introduced, with the functions of sale, delivery and transport of gas being clearly separated. Formally this means the implementation of the conditions of the Brussels Declaration of 23 March 2009, as Ukrtransgaz will take over the function of the independent operator of gas mains, and the operators of the regional networks will be separate legal entities. At same time, this requires a decision to restructure Naftogaz at a root and branch level, and not simply to institute the financial independence of the entities composing this company. Currently, the designated operator (Ukrtransgaz) is a daughter company of Naftogaz, and its board of directors is appointed by Naftogaz, which controls and regulates its operation. Nor is Ukrtransgaz the owner of the assets exploited. The new law is ambiguous in its regulations concerning the full independence of the operator of the gas mains – in so-called integrated economic entities, it requires only financial autonomy and the separation of

personnel functions. The operator will not set a rate for gas transport, because this function is delegated to the State Commission for Regulation of Energy (SCRE).

The liberalisation of the gas market itself (one-third of which is delivery to industrial customers) does not mean that free competition will be allowed. A law stating a free market for the sellers and suppliers of gas does exist, but their activity is regulated by licences issued by the SCRE. The awarding of licences in Ukraine is to a great extent an arbitrary matter, and the Commission itself, although formally independent, remains completely subjugated to the government. Obstacles to competition are also posed by another regulation, which orders state firms extracting gas in Ukraine to sell it to Naftogaz (only private firms are exempt from this obligation). These entities, in which the state has shares of at least 50%, must still sell gas to Naftogaz at prices (which vary depending on the costs of extraction) set by the SCRE. This gas is earmarked for the general public and the heating sector. Because extraction by private firms is of no great importance to the overall volume of gas traded, regulated prices will apply on this part of market.

Other clauses in the new law strengthen the SCRE's position – and by the same token that of the government – in regulating how the market functions and the activity of individual entities. The law does not consider another EU directive from 2009, which limits access to the market by external investors which do not meet the criteria of the separation of functions. Thus, even if the market is partially liberalised, the law opens up the chance for Gazprom to expand onto the Ukrainian market, which over the last year had to some extent been limited. Despite clauses in a bilateral agreement, and being granted a licence to sell 7.5bn m³ of gas annually to industrial customers, in 2009 GazpromSbyt Ukraina only sold 2.8bn m³ to this group of customers. Apart from the global economic crisis, which reduced demand for gas, this state of affairs was influenced by the government's price and regulation policy. The new law will fully liberalise delivery to this group of customers.

Gas price rises

From 1 August, prices in Ukraine will rise by 50% for the general public and the heating sector. These rises will not guarantee profitability for those selling gas to this segment of customers. It is estimated that prices for the heating sector are currently nearly 70% lower than the price of imported gas, and prices for the general public are one and a half times lower. These gas prices, which the government set at an economically unjustifiable level, seriously limit their market competitiveness. The current government was opposed to raising gas prices, and as a consequence also to raising the communal rates for the heating and delivery of hot water (by 20 to 25%). However, it was obliged to meet the IMF's conditions in order to receive another tranche of the stand-by loan which was necessary to cover the budget deficit. In contrast to the government of Yulia Tymoshenko, which twice pulled back from a decision to raise prices as agreed with the IMF, the current government has met this condition. The gas price rises this year will not be repeated. It is hard to predict whether the government will decide on further rises in order to bring the prices closer to the market rates, a move which would make a real liberalisation of the market possible. The president set himself these targets in the programme of reforms he announced. The Party of Regions' consolidation of its hold on government will make it easier for the current ruling team to take such unpopular decisions.

Summary and conclusions

1. The solutions implemented so far are to a large extent result of action by the EU and pressure from the IMF on the Ukrainian government. They indicate that the government is interested in maintaining its cooperation not only with Moscow and Gazprom, but also with the West.
2. The new law concerning the gas market and the gradual implementation of market conditions on prices may lead to the liberalisation of this market according to the solutions acceptable to the EU. However, this will depend on further steps towards a genuine restructuring of Naftogaz and stricter regulations being imposed by the SCRE, such as a transparent licensing process.
3. The solutions accepted in the new law may also, despite its declared aims, lead to interference with access to gas extraction concessions for private investors, both Ukrainian and foreign. This would mean that the state would retain its important influence on the activity of the main gas-related entities, and on the direction of any 'free competition'.
4. Gazprom may take advantage of the liberalisation of regulations on the choice of gas sellers and suppliers, so that it can strengthen its presence on the Ukrainian gas market, at least up to the level of the licence which it already possesses.