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Dark clouds over the Ukrainian gas market reform

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In September, three out of five members of the supervisory board of Naftogaz, Ukraine's largest gas company, announced their resignation and accused the government of stepping up political interference in the company's activity and blocking measures aimed at reforming the company. This represents yet another instance of the fight for control over Naftogaz and its profit-making subsidiaries, Ukrgazvydobuvannya (which extracts over 70% of Ukraine's gas) and Ukrtransgaz (the transit pipeline and gas storage facilities operator), which has been gaining momentum in recent months. On one side of the dispute lies what is broadly understood as the ruling camp (the surrounding of the president and the prime minister), while the other side is the pro-reform management of Naftogaz, headed by Andriy Kobolev and backed by Western institutions.
It seems that the government's goal is to regain control over Naftogaz, including over financial flows between its subsidiaries. The mounting conflict has resulted in a cessation of the gas sector reform, which has been ongoing for over a year. Reforming the gas market had hitherto been viewed as one of the biggest successes of the state modernisation programme that was launched after the Maidan Revolution. Moreover, this halting of the reform process poses the risk that it may subsequently be abandoned entirely.

The status of the gas sector reform

The gas sector reform process, which is part of the key reforms undertaken by Ukrainian state, was started in April 2015, when the Ukrainian parliament passed a law on the gas sector . The law provides, among other things, for unbundling the state-controlled company Naftogaz into companies dealing with gas extraction, transport, distribution and storage. This is to be accompanied by the creation of a competitive gas market in line with the rules of the EU's so-called Third Energy Package. Gas reform is of key importance for Ukraine due to Naftogaz's significance for the condition of public finances (in 2014, the company recorded a deficit of 106.6 billion hryvnias, which accounted for 6.7% of Ukraine's GDP) and the fact that since the 1990s the trade in gas has been a major source of 'corruption income' for Ukrainian ruling elites. At the same time, this also makes the reform exceedingly difficult to carry out[1].
Under the reform implementation, a process was launched to marketise the (formerly subsidised) prices of gas paid by individual customers, resulting in several subsequent price hikes. This considerably improved Naftogaz's financial standing – in 2016, for the first time in history, the company recorded a profit (of around US$ 1 billion). In May 2016, a new company supervisory board was appointed; it included three foreign members (citizens of the United Kingdom). This was intended to guarantee

[1] For more see W. Konończuk, Reform #1. Why Ukraine has to reform its gas sector, OSW *Commentary*, 2 September 2015, https://www.osw.waw.pl/en/publikacje/osw-commentary/2015-09-02/reform-1-why-ukraine-has-to-reform-its-gas-sector

the board's independence (the remaining two board members were appointed by the Ukrainian government). In July 2016, the government approved a plan to restructure Naftogaz, which provided for the removal from its structure of transit gas pipelines and gas storage facilities, and for transforming them into two independent companies: Main Gas Pipelines of Ukraine (MGU) and Underground Gas Storage Facilities of Ukraine. The unbundling will happen no sooner than 30 days after the Arbitration Court in Stockholm has passed a binding verdict in a dispute between Naftogaz and Gazprom.

In recent months, the government has been limiting the actions by Naftogaz's management – the promoter of the reform enjoying support from EU institutions.

This is expected to happen within a couple of months. In September 2016, the Ukrainian parliament, for its part, passed a law on establishing a new energy market regulator, which was an important move for continuing the reform (the regulator is expected to achieve full independence no sooner than in early 2019)[2]. It should be emphasised that these actions were carried out to meet the conditions set in the cooperation programme between Ukraine and the IMF and to enable Ukraine to receive subsequent instalments of financial aid.

In subsequent months, the government carried out activities which were de facto intended to limit the freedom of action by Naftogaz's executives – promoters of the reform, who enjoyed support from EU institutions. In September 2016, the Ministry of Economic Development and Trade decided to deprive Naftogaz of control over Ukrtransgaz and place the latter under direct supervision by the ministry. Officially, this happened on the basis of a request submitted by the then head of Ukrtransgaz, Ihor Prokopiv. Following criticism from the EU, the IMF and the Energy Community, all of whom viewed this move as standing in contrast to Ukraine's commitments regarding the implementation of the Third Energy Package, Ukraine's government withdrew from its decision. In March 2017, the Ukrainian government decided to expand Naftogaz's supervisory board from five to seven members. The aim of this move was to deprive the three independent board members of their dominant position in the board – they typically supported the company's management. Due to the composition of the committee tasked with selecting two new members, the selection of pro-government individuals was merely a matter of time. This, in turn, would result in the government gaining effective control of the supervisory board, and thereby of Naftogaz's management. The government's decision triggered protest on the part of independent board members, who then threatened to submit their resignation for the first time. At the same time, the forming of the new composition of the energy regulator has already been delayed by several months, which undermines the energy market reform as a whole.

Over recent months, international institutions (including the EBRD[3] in April and the IMF[4] in September) have repeatedly criticised Kyiv for the delay in implementing the gas sector reform measures and emphasised the risk of regression in the implementation process. In particular, they pointed to the attempt by the government to retain full control over companies in the gas sector, which involves limiting the process of

[2] T. Iwański, Ukraine: new regulator of the energy sector, *OSW Analyses*, 28 September 2016, https://www.osw.waw.pl/en/publikacje/analyses/2016-09-28/ukraine-new-regulator-energy-sector

[3] P. Polityuk, N. Zinets, EBRD says reform of Ukraine's Naftogaz in danger of unravelling, Reuters, 11 April 2017, http://uk.reuters.com/article/ukraine-crisis-naftogaz-ebrd/ebrd-says-reform-of-ukraines-naftogaz-in-danger-of-unravelling-idUKL8N1HJ27T

[4] S. Musaieva, D. Lipton, IMF: Ukraine risks reversing, *Ukrayinska Pravda*, 15 September 2017, http://www.pravda.com.ua/eng/articles/2017/09/15/7155220/

expanding the competences of the companies' executive bodies that is intended to reduce the government's potential for interfering in their activities.

The dispute over Naftogaz's subsidiary companies

Following their resignation, the independent members of Naftogaz's supervisory board accused the government of interfering in the activities of Ukrtransgaz (UTG) and Ukrgazvydobuvannya (UGV), the most profitable companies in the structure of Naftogaz, and of disrupting the preparations for the unbundling process.

The new management board of Ukrgazvydobuvannya has launched internal reforms and plans to increase its output to 20 billion m^3 by 2020.

In February 2017, Naftogaz's supervisory board dismissed Prokopiv due to his alleged misappropriation of funds worth around US$ 80 million, which was reported in the company's internal audit and in an audit carried out by international audit company, Deloitte. In response to this, a few weeks later the government appointed Prokopiv deputy minister of energy responsible for the gas sector, including responsibility for the supervision of Naftogaz. In an open letter, the supervisory board members mentioned the appointment as deputy minister of an individual compromised by corruption charges as one of the reasons behind their resignation. On 22 August 2017, Paweł Stańczak (formerly an employee of PGNiG Technologie S.A.) was appointed CEO of UTG, but his nomination was blocked by the Security Service of Ukraine (controlled by the presidential camp) which refused to issue a certificate to enable him access to classified information.

Another illustration of the dispute between the government and Naftogaz is given by the situation concerning the transit pipeline network. In November 2016, an operator company MGU was created. However, so far only its director has been appointed (a person associated with deputy minister Prokopiv), and the process of appointing an independent supervisory board is being blocked. Moreover, the government is delaying the implementation of the plan to separate gas storage business from Naftogaz and to transform it into an independent company. According to Naftogaz's executives, the inclusion of gas storage in the MGU would torpedo any chances of attracting a Western investor to the company (negotiations are underway with four companies from the EU). In September 2017 the government announced a plan to add the MGU to the list of state-controlled companies which are exempt from privatisation, which would rule out this option.
Ukrgazvydobuvannya, for its part, is Ukraine's largest producer of gas, with its output accounting for 73% of the country's gas extraction (14.6 billion m^3 in 2016), and at the same time constituting a major source of 'corruption income' for the Ukrainian leadership[5]. In 2015, a new management board was appointed at UGV, headed by Oleh Prokhorenko, who launched internal reforms and announced the "20/20" programme intended to increase the company's output to 20 billion m^3 by 2020. To achieve this, new drilling equipment has been purchased, external subcontractors have been hired to perform the bores, and the hydraulic fracturing technology has begun to be applied on a wide scale. These efforts have made it possible to halt the decline in the output recorded

[5] One example of this can be the actions by Ukrainian parliamentary deputy Oleksandr Onishchenko. See Після ліквідації схем Онищенка «Укргазвидобування» почало приносити прибуток, Укрінформ, 23 November 2016, https://www.ukrinform.ua/rubric-economy/2125905-pisla-likvidacii-shem-onisenka-ukrgazvidobuvanna-pocalo-prinositi-pributok.html

hitherto and to increase the output by 3.5% between January and August 2017 (in August alone an increase of 7% was recorded). Alongside this, Prokhorenko launched a reform of UGV to boost the company's transparency – for example, he terminated all contracts relating to joint ventures (under these contracts 210 bores were being exploited), which had been used to siphon off funds from the company. These actions quickly resulted in a boost to UGV's profitability – its net profit increased from just US$ 6 million in 2015 to almost US$ 500 million in 2016. Attempts to eliminate corruption mechanisms at the company, in particular in the field of public procurement, did not pass unnoticed by the government. First, a campaign to discredit Prokhorenko was launched in the media, and later, starting from the beginning of 2017, the General Prosecutor's Office and the Security Service of Ukraine ordered a series of searches to be carried out at UGV's head office.

The government order solidifies the actual monopoly of the owners of oblgazes over a large portion of the gas market and undermines its reform.

These are not the only actions targeting UGV. In late August 2017, the company issued a statement in which it accused the State Geology and Natural Resources Service of intentionally withholding the decision to prolong UGV's licence to exploit gas fields. As a consequence, licences relating to 5 gas fields have expired and the licence to extract gas from the Shebelinka gas field, one of Ukraine's largest gas fields, will expire in October. If this happens, UGV estimates that its gas output will decrease by 3 billion m^3 annually[6]. The requests the company had submitted to prolong the licence were repeatedly rejected. This should be interpreted as actions intended to compromise Prokhorenko and provoke his dismissal.

The monopoly of the oblgazes is sustained

Another element of the conflict between the government and Naftogaz is the price of gas paid by households. At present, it is being regulated by a market regulator which is associated with the presidential camp (the segment of gas supply to industrial recipients was opened to free market competition several years ago). In 2014–2017, as a result of a series of major price rises required by the IMF, the price became near to the market value. The government, for its part, committed itself to reviewing the price of gas regularly (twice a year) to avoid excessive discrepancies between the price paid by households and the price paid by industrial recipients. According to the adopted formula, in October 2017 the price should be increased by 17%. Naftogaz is not the only actor to request this. It is mainly the IMF that quotes this as one of the conditions enabling it (if met) to grant another loan instalment to Ukraine. However, Prime Minister Volodymyr Groysman has ruled out the price increase scenario and Ihor Nasalyk, minister for energy and the coal industry, said it is likely that the price would even be reduced. In the context of gas supply for households, regional gas distribution companies (oblgazes and miskgazes) represent an additional problem. Most of them (over 70%) are controlled by oligarch Dmytro Firtash. Since 2014, Firtash has been under house arrest in Vienna in connection with a motion requesting his extradition to the United States, where he is to face corruption charges. The 2015 gas market law introduced the ownership unbundling commitment in relation to companies dealing with gas transport and sale. The owners of oblgazes have found an easy way to bypass this require-

[6] Через бездіяльність Державної служби геології та надр Україна може втратити 3 млрд куб. м газу на рік та більше 28 млрд грн бюджетних коштів, Укргазвидобування, 31 August 2017, http://www.ugv.com.ua/page/cerez-bezdialnist-derzavnoi-sluzbi-geologii-ta-nadr-ukraina-moze-vtratiti-3-mlrd-kub-m-gazu-na-rik-ta-bilse-28-mlrd-grn-budzetnih-kostiv

ment – in each oblgaz and miskgaz a separate company was established to perform the sale of gas to households; these companies became known as oblgaz-zbuts. In March 2017, the government issued an order committing Naftogaz to supply gas to 44 oblgaz-zbuts at a preferential price set by the government and for the amount they would request. This solution solidifies the actual monopoly the owners of oblgazes have over a large portion of the gas market and prevents this market from being reformed. The government's decision was criticised by Naftogaz, and in August 2017 the Energy Community (EC) Secretariat and the World Bank published an open letter which contained a warning that the government order contradicts Ukraine's commitments towards the EC, and initiated proceedings to investigate the matter[7]. The EC drew up proposals of changes to foster competition in this market segment and forwarded them to the government of Ukraine, which has nevertheless failed to respond.

The end of gas sector reform?

The situation around Naftogaz indicates that the dispute between the government of Ukraine and the management of Naftogaz is of a systemic nature because the goals and visions of the future adopted by the two sides are mutually exclusive. The government's actions in recent months, including the blocking of the process of transferring certain responsibilities (which at present are vested with the government) to gas companies' executive bodies, de facto mean that the reform process at Naftogaz has been suspended and that the government intends to retain control over the company, which is Ukraine's biggest tax payer. These actions stand in marked contrast to the key assumptions of the gas sector reform.

The resignation of the independent members of Naftogaz's supervisory board ensures the board's paralysis for at least several months or until new members are appointed (at present the board has only one member – the former energy minister supported by the Petro Poroshenko Bloc). This will result in the government increasing its influence on how the company functions. The position of Naftogaz's management has strengthened as a result of the successful diversification of the import of gas to Ukraine, the victory in the Arbitration Court in Stockholm in the first dispute with Gazprom, and – most importantly – thanks to the support it receives from the West. These advantages may soon be insufficient in the context of mounting pressure from what is broadly understood as the ruling camp (both the presidential centre and the prime minister's centre). Due to the upcoming elections, the government will be unwilling to make decisions that would affect its approval rating, including further liberalisation of the gas price paid by households. The stabilisation of the economic situation and the success in entering the international lending market[8] have increased the government's resistance to requirements formulated by Western creditors. So far, these have been the main promoters of reforms in Ukraine and the defenders of Naftogaz's executives.

Another important aspect of the present dispute as a whole is the government's intention to install its people in the management bodies of Naftogaz's most profitable companies. These people would for example be expected to guarantee funding for the electoral campaign, which is extremely costly in Ukraine.

[7] Ukraine urged to reform public service obligation scheme in the natural gas sector, Energy Community, 25 August 2017, https://www.energy-community.org/news/Energy-Community-News/2017/08/25.html

[8] S. Matuszak, Udana sprzedaż obligacji przez Ukrainę, *Analizy OSW*, 20 September 2017, https://www.osw.waw.pl/pl/publikacje/analizy/2017-09-20/udana-sprzedaz-obligacji-przez-ukraine

Since 2014, the new management boards of Naftogaz and Ukrgazvydobuvannya have considerably curbed the corruption that had hitherto been endemic. However, this process is far from irreversible. At present, in the context of the prospect of the government taking over control of Naftogaz, a real threat has emerged that the old corruption schemes may return. This would spell not only a halt in the process of gas sector reform but even its regress.

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