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Modernization and Expansion of the Gas Transportation System Will Create Positive Macroeconomic Effects for Ukraine (interview)
by A. Konoplyanik

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Andrey Konoplyanik:

"Modernization and expansion of the gas transportation system will create positive macroeconomic effects for Ukraine"

3 March 2009 - The subject of the international consortium that is supposed to take over management of the Ukrainian gas transportation system (GTS) comes up each time the recurrent risk of bankruptcy of NAK Naftogaz Ukraine appears imminent. And each time this subject is hushed up on some kind of political pretext. Andrey Konoplyanik, advisor to the board of Gazprombank and one of the leading gas industry experts, shared his vision of the structure of the potential consortium with "Ekonomicheskie Izvestia" (Economic News, EI).

Andrey Alexandrovich Konoplyanik *received an education and defended dissertations for the PhD (Economics) (1978) and Doctor of Economics (1995), both in international energy economics, at Moscow State Academy of Management. From 1991 to 1993, he was Russia's Deputy Ministry of Fuel and Energy responsible for Foreign Economic Relations and Direct Foreign Investments. He was involved in developing Russia's Energy Strategy to 2020. He headed a group of drafters of the legislation on production-sharing agreements under the State Duma. From March 2002 through May 2008, he was Deputy Secretary General of the Energy Charter Secretariat in Brussels. He is currently an advisor to the Board of Gazprombank (Moscow). He is a member of the International Bar Association, the International Association for Energy Economics, and the Association of International Petroleum Negotiators.*

QUESTION: At the Europe-Ukraine Forum held last week in Kiev, you stated that the Russian-Ukrainian gas crisis could be repeated as early as March 7. What are the premises for this?

ANSWER: Yes, unfortunately such risk does exist. On December 29, 2008, audit firm Ernst & Young published the consolidated financial statement of NAK Naftogaz Ukraine and noted systemic financial risks that posed a threat to NAK's planned solvency in 2009. Signs have recently appeared of growing payment defaults by Ukrainian consumers in amounts that could result in the inability of Naftogaz to settle contractual obligations with Gazprom within the framework of the monthly system of settlements for gas supplied for Ukraine's domestic consumers. However, if Ukraine fails to pay Russian suppliers for any preceding month no later than the 7th day of each following month, the parties shift to 100% prepayment for supplies for the whole period up to expiry of the contract. At the same time, if the buyer (Naftogaz) fails to fulfill or is late in fulfilling its contractual obligations, the seller (Gazprom) has the right to unilaterally stop or suspend gas exports to Ukraine partially or fully. The absence of Russian gas export volumes in Ukraine's gas transportation system will lead to disbalancing of the system, which after several days will make it impossible to simultaneously guarantee transit supplies and domestic gas demands. The most likely outcome is that transit will be halted in favor of supplying the domestic market, as happened in January this year.

QUESTION: Why do you think this scenario is the most likely?

ANSWER: Because the inability of Ukraine's GTS to simultaneously guarantee transit and domestic gas demand without supplies of Russian gas to Ukraine is a deep-seated problem of Russian-Ukrainian gas disputes. This means that reliable transit of Russian gas to Europe via Ukraine depends on Ukraine's payment discipline for Russian gas imported for domestic consumption.

Despite the actual contractual separation of Russian gas exports to Ukraine and Russian gas transit through Ukraine, as well as the transition to differing and unrelated export pricing and transit tariff-setting methodologies, transit remains technologically dependent on contractually unrelated exports to Ukraine.

Construction of new by-passing pipelines (Blue, South, North Streams) can solve the problem of securing transit for new Russian supplies (by escaping transit at all), but for major volumes of Russian gas transit flows to Europe (through Ukraine) the above mentioned problem – technical in its nature – still stays unsolved.

QUESTION: What might be the optimal solution for the problem of ensuring reliable transit of Russian gas to Europe through Ukrainian GTS?

ANSWER: A comprehensive solution for this problem must obviously assume:

1. Speedy, process-oriented (technological) separation of the functions of the integrated Ukrainian GTS as both a transit system and a system supplying gas to Ukraine's domestic market for separate functioning as a transit system and as a system for domestic supplies.
2. A proactive integrated solution for the imminent crisis of Naftogaz failure to pay for gas import purchases, primarily to avert another gas crisis in March of this year and the following potential monthly crises at 7th date of each next month.
3. Solving the problem of technologically and economically stable performance of the domestic gas supply system (with consideration of the social component of this problem).

The transit function of the Ukrainian GTS must be separated both operationally (technologically) and commercially. Here we are talking about targeted modernization of the transit-oriented part of the existing Ukrainian GTS as standalone transit system.

QUESTION: How much time and money will be needed for this?

ANSWER: From several months to several years and substantial investments, which could be presented on the principles of project financing (under this scheme today's project investments will be collaterized by future uninterrupted transit income flows generated by the project itself). The objective must be to create a standalone, stably operating transit GTS that is independent of other kinds of activities not associated with providing transit and has operational control of the corresponding pipeline assets (privatization of any such Ukrainian assets is prohibited by Ukrainian law). The value of this transit organization (in terms of project financing a so-called "special purpose company" or "project company") is determined by the difference between the amount of transit income (total value of accumulated transit tariffs for pumping Russian gas, usually for 10-year period) and expenses (for creating and maintaining operation of this transit system). Based on the amount of annual income from the transit of Russian gas — about $2.5 billion (120 billion cu. m × $1.71 / 1,000 cu. m / 100 km × 1,250 km) — the approximate value of this organization can be roughly estimated at $25 billion. Under the Russian-Ukrainian gas contract, the estimated value of gas supplied to Ukraine in 2009 is about $14.4 billion. Thus, within only a few months, Naftogaz payment defaults could reach such amount of debt to Gazprom, that repaying it with the new company's assets (if this were possible) would result in Naftogaz losing control over it. But, first of all, privatization of Ukraine's GTS is prohibited by law. Second, even if it were legally possible, the current political powers in Ukraine, as I see it, would not be inclined to alienate this state-owned property in favor of Russian structures. However, I'm not convinced that this same inflexibility will be shown towards EU structures (governmental, quasi-governmental, and commercial). Especially given the European Commission's support (judging from statements by EU Commissioner for Energy Andris Piebalgs) for Ukraine's accession to the Energy Community Treaty of the EU with South East European countries, which extends EU energy legislation to member countries of this treaty. Therefore, Naftogaz debt to Gazprom (if it arises) could be paid by a third interested party — the EU structures, since Ukraine becomes part of the "energy" EU. All that is needed is a mutually acceptable formula for coordinating the interests of all three interested parties (Ukraine, Russia and the EU).

QUESTION: What is your concept of this formula?

ANSWER: On Ukraine's accession to the Energy Community Treaty of the EU with South East European countries, Naftogaz will have to undergo mandatory unbundling into competitive and natural monopoly components. Therefore, within a year (or some other reasonable period), I will propose that Naftogaz Transport will face additional unbundling of its gas transport component (the present Ukrtransgaz) into Naftogaz Gas Transit and Naftogaz Domestic Gas Transport. These split-off business units (special purpose companies) will become operationally and commercially standalone and independent operators of the corresponding GTS divisions.

In my opinion, the optimum shareholder structure for the operator of Ukrainian transit GTS would be a trilateral consortium that would include representatives of the supplier country (Gazprom), transit country (Naftogaz Transport or Ukrtransgaz) and the consumer countries (companies of EU member countries and EU financial institutions). On the European side, the participation not only of gas companies that are buyers of Russian gas, such as E.ON Ruhrgas AG (Germany), Gaz de France (France), Eni (Italy), OMV (Austria), etc., but also financial institutions controlled by the EU (like the European Investment Bank - EIB) and by all interested countries in the Russia-Ukraine-EU chain (like the European Bank for Reconstruction and Development - EBRD) is advisable. In this case, European structures that are shareholders of Naftogaz Gas Transit, primarily EU financial institutions, would be able to offer guarantees of Naftogaz Domestic Gas Transport payments for Gazprom current export supplies to Ukraine backed by assets of Naftogaz Gas Transit owned by Naftogaz Transport.

QUESTION: How could this formula work in the context of cooperation between Naftogaz and Gazprom?

ANSWER: In the event of another crisis of nonpayment by Naftogaz, the Gazprom demand for debt repayment would be automatically redirected to the EU guarantor. If European financial structures are the guarantor (EIB or EBRD), there will be no need to convert Naftogaz tangible assets into cash needed to pay the debt. That is, there will be no depreciation of Naftogaz assets, which would be inevitable if there were a levy against them. Likewise, as arrears for gas supplied to Ukrainian domestic market accumulated, Naftogaz assets would not be alienated in favor of Gazprom, as Ukrainian current political leaders fear, but rather in favor of European structures. In the proposed formula, even if there was a change in the shareholder structure of Naftogaz Gas Transit due to a reduction in Ukraine's share, it would be in favor of EU structures through a standard debt-for-equity swap mechanism, which would integrate Ukrainian economy even more closely into the EU economy.

This is very desirable for the country's political leadership. If Naftogaz Gas Transit is set up as a closed joint-stock company, a limit can be set on alienation of a share of Naftogaz equity capital in favor of other shareholders. If it is set up as a open joint-stock company — in favor of third parties. In this case, on expiry of the specified period, EU structures should/may have the right to subsequent resale, including to the Russian shareholder (Gazprom), of part of their shares in Naftogaz Gas Transit received from debt repayment. EU financial structures must have the right to sell their entire share on expiry of the specified period. All of this could happen when the NAK financial situation is straightened out, including by means of accumulated proceeds from uninterrupted transit. In my opinion, the optimum final shareholder structure of Naftogaz Gas Transit would be to have two blocking shareholdings — Gazprom and Naftogaz — and minority shareholdings of four or five European companies/institutions (see Figure). Why blocking shareholdings for these two? In the case of Naftogaz, because it represents the transit country, which owns the pipeline assets through which the Russian gas is transitted to the EU. In the case of Gazprom, because it is Gazprom who is the owner of the gas transitted to the EU through the pipelines belonging to Ukraine. And it is Gazprom who, under its long-term contracts for the supply of Russian gas to Europe, is responsible for secure delivering its gas via Ukraine to delivery points located within EU territory.

Naftogaz Gas Transit will be economically viable, because it will derive a stable flow of income from transit of Russian gas. After this company has been established and the Ukrainian GTS has been operationally separated into transit GTS and GTS for domestic consumption, payment defaults on Russian gas export supplies to Ukraine will not lead to operational shutdown of the transit of Russian gas to Europe.

However, it should be understood that this operational separation is a complex investment project equivalent in scale to constructing two new 1,420-mm-diameter branches affecting pipeline facilities both in Ukraine and in Russia at the inlet to the Ukrainian GTS.

QUESTION: How does this formula fit into Gazprom plans to build gas pipelines bypassing Ukraine?

ANSWER: Naftogaz Gas Transit could build additional transit facilities through Ukraine, which may be cheaper than building pipeline routes bypassing Ukraine. And reliable transit through Ukraine as a result of this scheme could make this same scheme preferable. In practice, this scheme could help strengthen Ukraine's role as a reliable transit country in the interests of all countries within the trans-border gas supply chain (producers — transit countries — consumers). Modernization and expansion of the GTS will create positive macroeconomic effects for Ukraine.

The second part of the separated Ukrtransgaz, the one responsible for supplying domestic demand, will experience financial shocks associated with subsidized gas prices, payment defaults, low gas utilization efficiency, and other consequences of the lack of adequate reform of the Ukrainian economy and its energy sector. But these reforms are necessary and unavoidable, especially in light of Ukraine's accession to the Energy Community Treaty of the EU with South East European countries. Some of the burden of these reforms must be placed on EU institutions, including financial institutions. In particular, some elements of reform could be financed through the EIB and EBRD.

QUESTION: To whom might this be favorable and why?

ANSWER: The formula described above takes the interests of the EU, Ukraine, and Russia into consideration. Most important, in my opinion, is that it reflects a key new concept that must enter into public consciousness after the events of January 2009: a guarantee of uninterrupted supplies of Russian gas through Ukrainian territory to EU countries directly affects all three interested parties. Therefore, an effective guarantee of this process is impossible today without the participation and cooperation of all three parties. Transit by definition is a multilateral task with at least three participating parties.

In particular, this formula will allow the EU to avoid another gas crisis by finding a long-term solution to the problem of securing the preconditions for reliable, uninterrupted gas transit through Ukraine. The EU will not have to allocate cash resources to solving the problem of guaranteeing reliable transit by means of this formula.

As an intermediate member of the proposed formula, the EIB is immediately prepared to stave off Naftogaz inability to make current payments for export supplies of Russian gas to Ukraine. The EIB share (and/or the share of other European financial institutions) should subsequently be sold on a nondiscriminatory basis. In this case, there is no need for immediate settlement of the question of which European companies participate in the Naftogaz Gas Transit equity capital along with the EIB.

QUESTION: And what is Ukraine's interest?

ANSWER: Ukraine will be able to break the vicious circle in which transit through Ukraine is held hostage to the problem of paying for export supplies to Ukraine in contravention of the provisions of Article 7 of the Energy Charter Treaty (ECT). Ukraine will be able to maintain and even strengthen its positions as a transit country. This solution will bring Ukraine closer to the EU and EU regulations. At the same time, Ukraine will no longer put the EU in the ambiguous situation where the EU must declare Ukraine guilty of violating ECT transit provisions but cannot (does not want to) do this in order to avoid siding with Russia in a transit dispute between Russia and Ukraine. Ukraine retains at least a blocking share and control of Naftogaz Gas Transit, which is protected from direct transfer of its assets to Gazprom. And Western institutions and companies will be involved in the process of competing for its share packages.

QUESTION: Finally, what advantages will Gazprom receive?

ANSWER: The company will be guaranteed reliable, uninterrupted transit of Russian gas through Ukraine to the EU:

- in the short-term outlook, since gas supplies to Ukraine will continue against guarantee by European institutions of payments from Naftogaz;
- in the long-term outlook, since the GTS will be separated into two independent, unrelated gas transportation systems — one for transit and the other for supplying the domestic market. If Naftogaz fails to pay (if this happens), Russia will be able to receive either adequate, timely monetary compensation from its European guarantors or increase its share in Naftogaz Gas Transit equity capital.

QUESTION: How was your idea received by forum participants?

ANSWER: I was not the only one with the idea that interested countries or their commercial structures needed to organize some kind of "triple alliance" in order to find the most effective solution to the problem. The idea of a trilateral consortium was also expressed in general form in other presentations of EU representatives. And Michael Emerson, a senior researcher at the Centre for European Policy Studies (Brussels) for example, went into specific details in his presentation (he was the official representative (ambassador) of the EU in Russia in the 1990s). However, his presentation was immediately criticized by an Ukrainian deputy for purportedly saying that European gas companies entering the consortium would be controlled by Gazprom. The deputy's second comment was that gas transit and Ukraine's energy security were political, not economic issues. My response to these comments is, as the saying goes, "no comment".

The details of Michael's and my proposals differed, but in my opinion, we agreed on the main thing: the need for a collective solution to the transit problem. I was questioned mainly on the economic side of the briefing issue. My suggestion is that this is an idea for discussion, an attempt to feel about for the optimum long-term solution to the problem. And if the discussion (which I hope will broaden the circle of participants with the help of your newspaper — my personal thanks for this), as a result, leads to another, more effective solution to the problem of guaranteeing uninterrupted transit of Russian gas through Ukraine to Europe, which is certainly in the interests of all three parties, – well, I would be very pleased as well.

***Conversation with Svetlana Dolinchuk**, 3 March 2009*

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Naftogaz & Naftogaz Gas Transit