NEWSLETTER

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Gas market: the direction is clear – but the devil is in the details

Ukraine has all structural preconditions in terms of market size and infrastructure to develop a well-functioning gas market. Also, the regulatory reforms of the past two years not only created a general legal framework but already enabled some market development. But important steps are still to be taken to make the wholesale gas market, the retail gas market, the balancing energy market, and pipeline capacity auctions functioning properly.

The coordination and sequencing of the individual reform steps is crucial. Otherwise the political climate (e.g. through steeply rising household prices), or the entrenchment of new vested interests could irreparably derail the reform process.

The direction is clear

The gas sector is of strategic importance for the development of Ukraine. Gas subsidies of up to 5% of GDP, corresponding high-level corruption schemes and the dependence on gas imports from Russia contributed largely to the economic and political malaise of Ukraine in the past two decades. The system was characterised by politically set prices that led to overconsumption, underproduction and huge inefficiencies in the gas sector. To overcome this, Ukraine needs a reliable price signal for natural gas on which (1) producers can base their production and investment decisions, (2) traders can base their import, export and stocking decisions, (3) consumers can make sure they pay a fair price and (4) which network operators, tax authorities and regulators can use as a basis for setting taxes, charges and regulated tariffs in a cost-reflective manner.

Such a price signal is best delivered by a competitive, transparent and liquid gas market. Important preconditions to develop a well-functioning gas market are already in place. The Ukrainian gas demand is sizeable (2016: 30.3 bcm) and shared between different consumers, gas can theoretically be supplied from several different sources (notably Russia, the EU, storages and domestic production) and non-discriminatory access to the pipeline system is legally postulated.

By becoming a member in the Energy Community Ukraine has committed itself to set up a competitive gas sector. Following the EU model there is not only one, but several markets that need to be developed in parallel in a coordinated fashion. In essence, there are four interacting markets:

1) A *wholesale market* at which gas producers and importers, large consumers and retailers as well as gas traders exchange gas volumes and form a transparent and reliable price signal.

2) A *balancing market* that allows gas market participants to cover imbalances at competitive prices.

3) A *retail market* in which final consumers can choose a retailer that provides the best service at lowest cost.

4) A *market for international gas transmission capacity* that makes the maximum amount of cross-border capacities available and allocates them to the highest bidder.

Key issues remain unresolved

None of the four markets is currently functioning sufficiently well in Ukraine. The *wholesale market* is the most developed segment of the gas market. Several domestic and (since recently) some foreign companies compete to supply gas to larger customers. So far, the predominant position of Naftogaz (around 75% of production and imports), remaining regulatory barriers, the absence of functioning gas balancing and retail markets, issues with international gas trading and the lack of appropriate financial services are holding back the development of a liquid wholesale market.

So far no *balancing market* exists. Gas metering still only happens on a monthly basis (in the EU daily or even hourly), which implies the need for substantial financial guarantees being provided by network users. The gas transmission system operator Ukrtransgaz recently started tenders for balancing gas (before it bought it from its mother company Naftogaz), corresponding software has been procured and a balancing code is under development. But continuing discussions around the role and independence of Ukrtransgaz (from both Naftogaz and the government) are not helpful for a swift implementation.

The *retail market* is held back by the lack of transparent and non-discriminatory access to the distribution networks. Those networks are still largely controlled by the regional supply companies (Oblgas), many of which belong to Group DF (owned by Dmytro Firtasch). As long as other gas suppliers cannot get fair access to the distribution grid, there will be no competitive retail market. Another issue is that under the current system of social support gas suppliers have to reduce the bills for households by a legally defined subsidy, which they shall get reimbursed from the state. The procedure of reimbursement is however taking time and creates risks for market participants. Thus, a substantial part of the cash-flow is frozen, which private companies would find difficult to accept.

Access to *cross-border capacities* is either controlled by Gazprom through the legacy contracts or Naftogaz that bought the newly developed import capacities from Slovakia.

Sequencing reforms

The four markets need to be developed largely in parallel as otherwise sectoral monopolies at any of the four levels can offset the benefits of competition for consumers. Retail monopolies would, for example, not pass through the benefit from competition on the wholesale level to final consumers, but keep it for themselves. Such rents to private business groups would be difficult to unwind, once introduced. In fact, the retail market was supposed to get deregulated in April 2017. This would deprive households of the regulated public gas supply services at relatively low rates. Given the lack of fair competition at the retail level, this step will be postponed.

At the same time, the market rules need to fit the sector structure. Even the best wholesale gas market model is going to fail, if one player dominates this market. Hence, market rules and sector restructuring need to progress in parallel.

In our view it would make sense to use the reform momentum for the three most difficult parts:

1) Cracking the retail monopolies by making gas distribution networks well-regulated and companies truly independent. This will meet fierce opposition from current owners.

2) Taking gas transmission out of the control of the government and the incumbent. The fastest and cleanest solution would be to transfer it to a strategic investor in a privatisation process. However, this is not only unpopular ("selling off the family silver"), but is also opposed by the parts of the government that fear to lose control over this strategic asset.

3) Restructuring Naftogaz in order to mitigate its dominant position on the wholesale market. This could be done by temporary schemes such as "gas release programmes" or structural measures such as privatisation of different gas production assets. But, Naftogaz should only be deprived of its upstream assets when a transparent privatisation can be ensured and only after Naftogaz' public service obligations are revoked. Otherwise there is a risk that Naftogaz is an empty, state-owned shell that can only meet its obligations, i.e. to supply the population and store gas in winter, by buying from producers that were privatised in an intransparent manner. This would be a shame, as Naftogaz' management is a crucial driver of reforms in the Ukrainian gas market.

Without those three difficult structural measures, no really competitive gas market in Ukraine can develop, irrespective of the legal basis.

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Note: A more comprehensive analysis of the topic is provided by the Policy Paper PP/01/2017 „Boosting gas trading in Ukraine".

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