

Gas sector reforms set to accelerate after 20 years

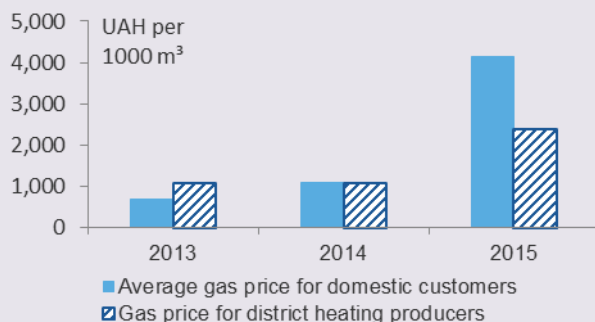
The government of Ukraine is planning far-reaching reforms of the gas sector to which it has committed at international level in accordance with the EU Association Agreement, the Energy Community and the IMF programme. The passing of a framework bill for the gas sector early in April was just the start: after all, the envisaged restructuring of the sector is a massive undertaking in which most of the technical details, many of the structural issues and even some of the responsibilities are still to be decided. The success of the project will also depend on accessibility of western expertise.

Reforming the gas sector is critical

Reforms to Ukraine's gas sector are extremely important in terms of the economic, financial and political development of the country. In recent years, the gas sector has played a major role in perpetuating dependence on Russia, causing difficulties with the balance of payments, increasing the national debt and corrupting the political system. Ukraine has now assured the EU, the Energy Community and the IMF of its commitment to deep-seated and indeed painful reforms of the sector. The reforms can be split into five categories: tariff adjustments, a new framework law for the gas sector, redesign of the gas market, an independent regulator and restructuring of Naftogaz.

Tariff adjustment

Ukraine has agreed to the substantial adjustments of gas and heating tariffs demanded by the IMF. The regulator has stipulated a 285% rise in household gas tariffs and a 120% rise of gas tariffs for district heating companies to take effect from 1st April 2015.



Source: Author's calculations based on figures from Naftogaz and CabMin

Abolition of the progressive tariff should ensure domestic tariffs cover 75% of costs by next year, with a further tariff increase finally eliminating the Naftogaz tariff deficit in 2017. To limit the social impact of these massive adjustments, programmes for socially disadvantaged households will be revised in partnership with the World Bank. To achieve this, the

measures will need to be targeted and incentives to save energy, even in low income homes, must be strengthened. In the medium term (by 2017), measures relating to energy costs will be incorporated into a general social safety net. The prices Naftogaz can charge for the gas it produces will also rise by 355%.

Given the high sensitivity surrounding the issue, it has been encouraging to see that the announced price hikes were not yet met with widespread resistance. Nonetheless, realisation of the tariff adjustment measures still entails a certain level of risk, especially when the general public realises the actual impact of the cost increase at the start of the next heating period.

Framework law for the gas sector

Early in April 2015, the Ukrainian parliament passed a framework law concerning the gas sector that was drawn up with the Energy Community. The law sets out a structural framework for the gas sector in Ukraine, covering such issues as the decentralisation of production and transport, non-discriminatory access to the network and competition on the retail market. However, the draft law leaves open a number of major questions, such as whether pipeline operators may own the pipeline network. Although the draft passes the European Acquis into Ukrainian law, including the many possibilities it confers, the thorniest issues – those involving money and power – are yet to be resolved. It also remains to be seen how Gazprom will respond to changes in legislation that contradict the gas transit agreement of 2009.

Redesigning the gas market

The issue of a redesign for the gas market (i.e. the question of which products will be traded, how prices will be set and the obligations on individual players) is still far from being resolved. Corresponding regulations will be drawn up by the regulatory authority with the approval of the Ministry of Energy and the gas industry; some issues might require further parliamentary authorisation. Technically speaking, this is a highly demanding task: within a short timeframe, Ukraine will be required to develop a completely new set of regulations that operate within European rules while taking account of Ukrainian peculiarities (the country features Europe's largest gas storages and is the most important gas transit country as well as a major gas producer in its own right). Alongside many other details, Ukraine will need to determine how many market zones there will be, who

will bear the network costs and who will be responsible for balancing the system. All of these questions can be answered in many different ways under European rules, which themselves remain in a state of flux. Producing a concept for a gas market that is coherent and beneficial to Ukraine while complying with European law, and facilitating its legally sound implementation is therefore a highly complex task.

An independent regulator

In EU member states, national regulators play an important role in defining market rules, tariffs for network access and investment planning. A law determining the duties and independence of the Ukrainian regulator is also set to be passed this year.

Restructuring of Naftogaz

The most-cited proposal on restructuring – from Naftogaz itself – envisages the breakup of the company, with the production division spun off into a state-owned entity controlled by the Ministry of Energy. The gas transmission network and gas storage would belong to another state-owned enterprise overseen by the Ministry of Infrastructure. Under the Naftogaz proposal, the gas network and gas storage would be operated by a public-private joint venture, thus ensuring modern management and transfers of knowledge.

Fiscal headwind

Given the highly fraught financial and supply situation that currently prevails, however, it has also been necessary to implement short-term measures that contradict the long-term objectives. For example, taxes on gas producers have been raised from 20% to 55%, while Naftogaz has temporarily obtained the exclusive right to sell gas to industrial clients in order to plug some of the financing gaps with the resultant revenue. These short-term, politically motivated measures not only spell hardship for independent gas producers and dealers, they are also jeopardising long-term investment in Ukrainian gas exploration.

Limited administrative capacity

A further difficulty lies in the fact that the aforementioned, highly demanding programme of initiatives is at odds with limited administrative capacity. Against a financially strained background and with a very short timeframe available, the reforms outlined will be tackled by a small and motivated yet inexperienced management group. Underlining the break with the past, the team is very young (the average age of the heads of the regulatory authority, Naftogaz and the Ministry of Energy is 33). At the same time, significantly better equipped interest groups will be aiming to influence the planned changes to suit their needs or block them altogether. The World Bank, the Energy Community office and

national NGOs are all in support of genuine reforms involving external expertise.

Conclusion

The need for technical support on issues as complex as network codes and regulation remains much greater than the supply. EU regulation experts from the national regulators or network operators could be particularly helpful to the Ukrainian regulatory agency, which will be compiling the regulations transposing the Gas Market Act relatively autonomously as things stand. Of course, in view of the extremely challenging circumstances – and especially the melange afflicting internal politics – technical support on its own is no guarantee that a viable market design can be developed. Without technical back-up of that kind (not to mention some unabashed peeking over the shoulder), it is hard to see how the Energy Acquis can be successfully implemented.

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Note: For a detailed analysis of gas sector regulation, see Policy Paper PP/03/2014 'Improving gas transmission network regulation in Ukraine by implementing Energy Community rules'

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