



Draft: Restructuring of Naftogaz

Considerations on scope and ownership of the business units

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Berlin/Kyiv, January 2016

Structure

1. Introduction
2. Arguments for and against privatisation
3. Arguments for and against integration
4. Conclusions

Two issues: ownership and scope of business units

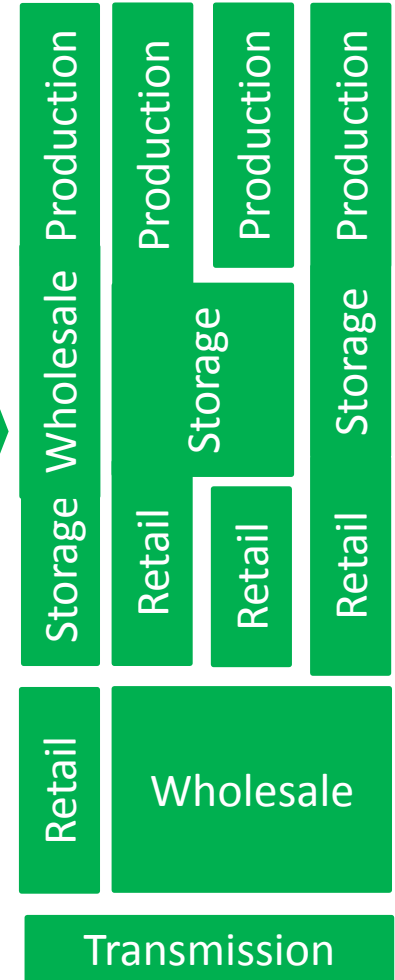
Public VIC



Private VIC + public transmission



Private restructured sector



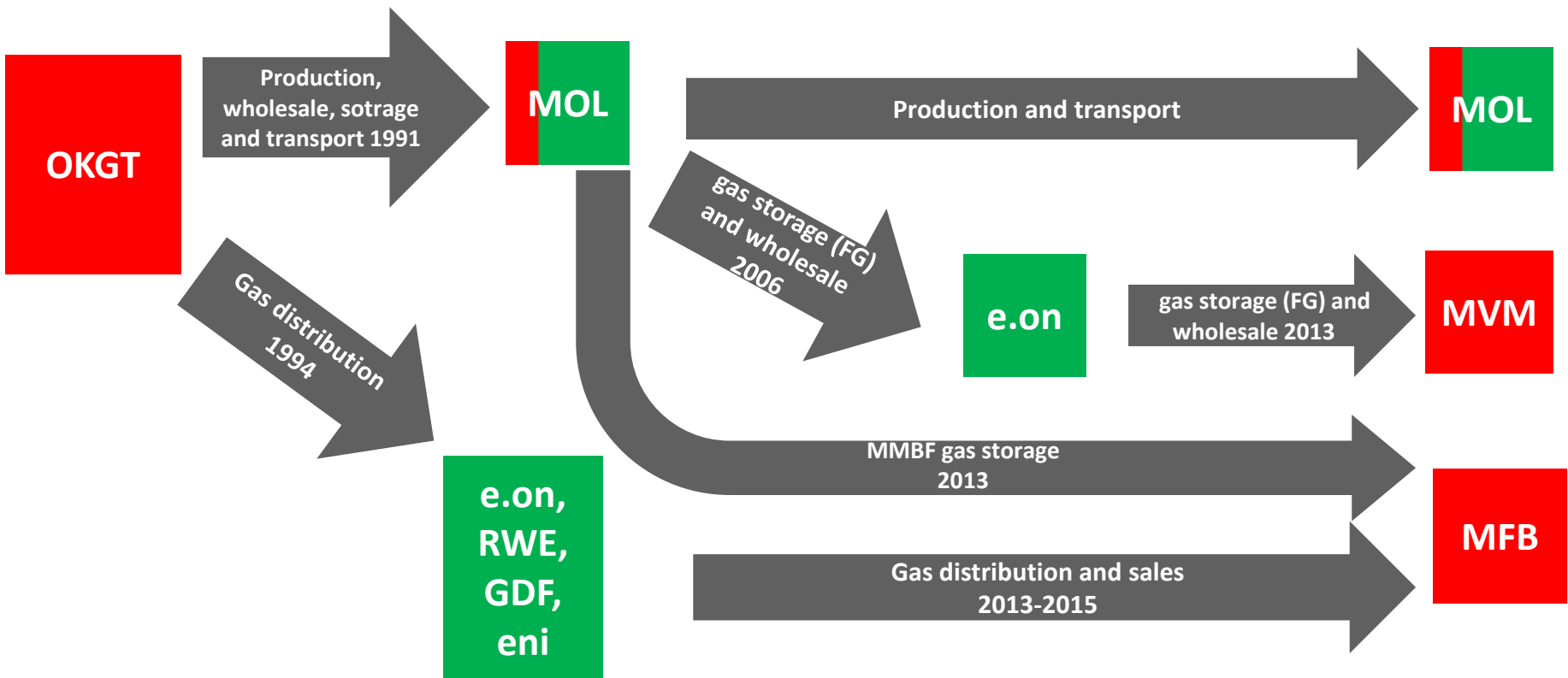
Selected major European gas companies

	HQ	Production	Wholesale	Storage	Transport	Distribution	Retail	Electricity	Share of private
EWE	DE								0%
MVM	HU								0%
EdF	FR								15%
PGNiG	PL								28%
Engie	FR								67%
OMV	AT								69%
SNAM	IT								70%
RWE	DE								85%
Uniper	DE								100%
E.on	DE								100%
Centrica	UK								100%
EPH	SK								100%

Source: company websites, January 2016

- No two companies have the same structure
- All forms of public vs. private shareholders ratios
- Idiosyncrasy makes evaluation very difficult

Example: Hungary – from state to private and back



Source: company websites and energyscee.com/2015/09/03/hungarys-gas-bill-perpetual-debt/

- **Initial privatisation stimulated transfer of knowledge and attraction of investments**

2. Arguments for and against privatisation

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Effects of privatisation

■ Capital cost

- Typically more expensive for private companies / but gov't might be capital constraint

■ Governance

- Might require less administrative capital (good public managers)
- Stricter supervision by private owners
- Less harm through non-"benevolent" political actors

■ Efficiency

- Higher incentives lead to higher efficiency
- More innovation
- Less non-economic objectives

■ Risk taking

- Insolvency risk avoids excessive risks

Impact in competitive segment

■ Prices

- Low in competitive segment (storage, sales, production), when competition is allowed

■ Investments

- More efficient investment decisions in competitive segment

■ Gov't Revenues

- Sum of taxes and dividend found to increase after privatisation in AT

■ Quality of service

- Incentive to provide better service

Impact in monopolistic segment

■ Prices

- Depend on regulatory framework in monopolistic segment (transmission, distribution)

■ Investments

- Better project selection
- Amount of investments depends on regulatory framework

■ Quality of service

- Depend on regulatory framework

Side benefits of privatisation

- **Increased market capitalisation** and trade volume in the national stock market
- **Improvement of national financial market regulation**
- **More efficient market entry:** Public companies tend to get an unfair advantage in competition (e.g., easier finance from public banks)

Arguments against large-scale privatisation

- **Regulation more complex** than direct control
- **Employment in privatised companies declines** (effect on aggregate employment unclear)
- Possibly **lower quality & less socially valuable objectives**
- Potential **increase in corruption**
- Risk of **“asset stripping”** by management
- **Unpopular**

On balance:

- **Gains in operational efficiency trump other effects!**

Success factors:

- Regulatory & Institutional Framework
- Competition
 - -> Break-up horizontal integration
- Ownership structure
 - Foreign investors improve productivity most (not offshore or RU)
 - Some public-ownership appears in many cases to increase value (political hedge, local knowledge,)
 - Having a minority shareholder also helps
- Acceptance by the population

3. Arguments for and against integration

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Benefits of divestitures

- Eliminate diseconomies of scale of large state conglomerates
- Improve managerial incentives
- Improve information flows [Decentralisation allows better use of local information (Hayek)]
- Focus on core competence
- Avoid political capture ('too big to fail')

Drawback of divestitures

- Remove scale efficiencies (e.g., joint IT)
- Integration provides implicit risk hedge
- Overcomes incomplete contract issue

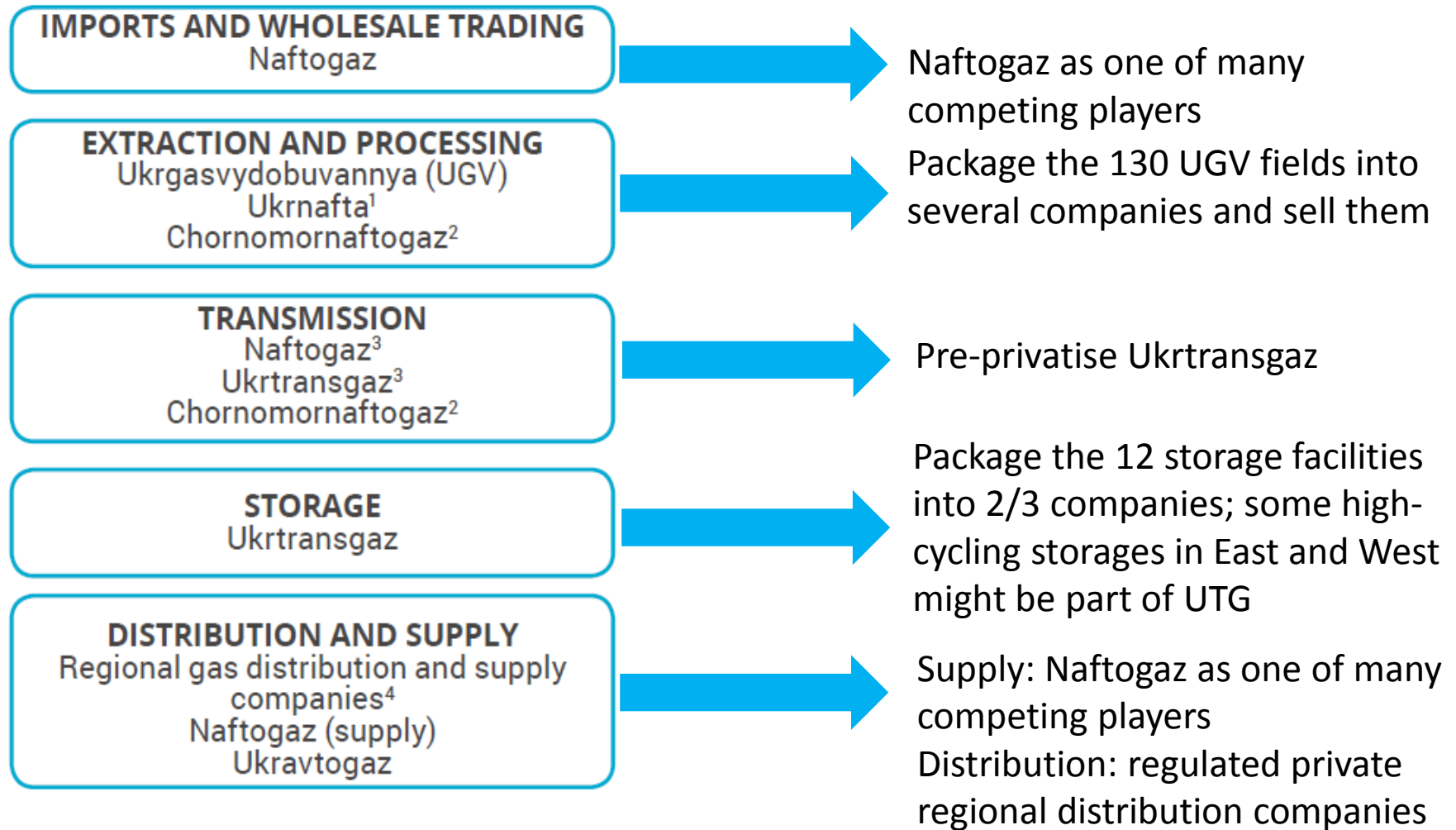
On balance

- Difficult to tell which business units should stay together (very different models, see EU example)
 - In general, institutional capital seems limited
- > Creative destruction
- slice holding in parts vertically and horizontally
 - Privatise the parts
 - let the parts trade and compete
 - let the parts eventually merge (they have to make a positive case for the merger then)

4. Conclusion

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Naftogaz' gas business restructuring: A bold proposal for discussion





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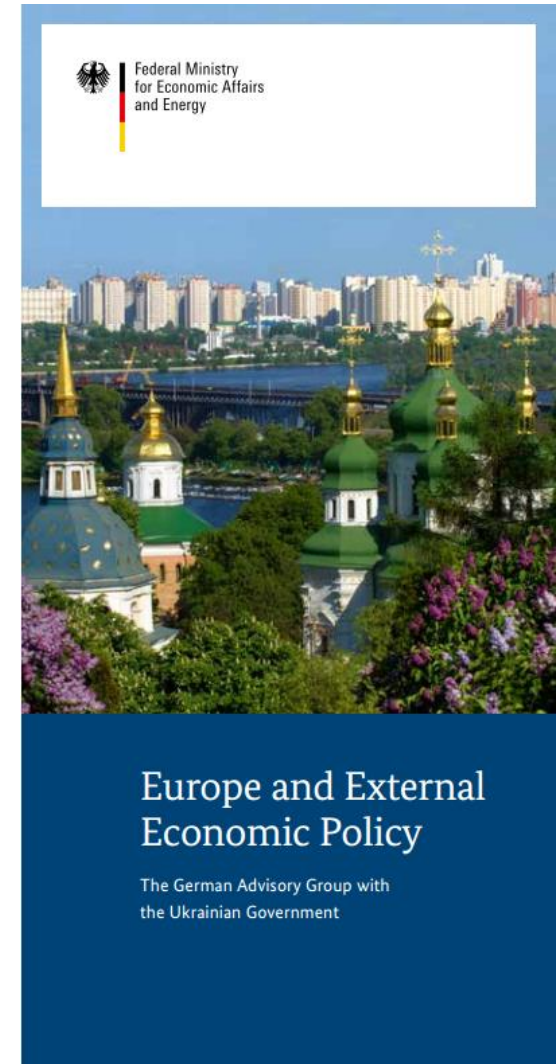
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Annex 1

KEY BUSINESS DIVISIONS

GAS

IMPORTS AND WHOLESALE TRADING
Naftogaz

EXTRACTION AND PROCESSING
Ukrigasvydobuvannya (UGV)
Ukrnafta¹
Chornomornaftogaz²

TRANSMISSION
Naftogaz³
Ukrtransgaz³
Chornomornaftogaz²

STORAGE
Ukrtransgaz

DISTRIBUTION AND SUPPLY
Regional gas distribution and supply
companies⁴
Naftogaz (supply)
Ukravtogaz

OIL

UPSTREAM
Ukrnafta¹
Ukrigasvydobuvannya (UGV)
Zakordonnaftogaz
Chornomornaftogaz²

TRANSMISSION
Ukrtransnafta
Ukrspetstransgaz
Chornomornaftogaz²

STORAGE
Ukrtransnafta
Ukrnafta¹
Ukratnafta⁵

REFINERY
Ukrigasvydobuvannya (UGV)
Ukratnafta⁵

DISTRIBUTION AND SUPPLY
Ukrnafta¹
Chornomornaftogaz²

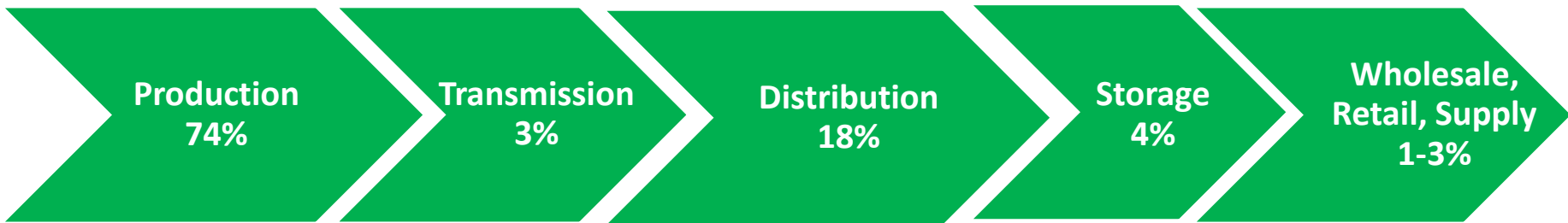
1. Naftogaz owns 50%+1 share of Ukrnafta but did not exercise control over the company in 2014 and started to recover it in 2015
2. As a result of the occupation of Crimea by Russia in 1Q 2014, Naftogaz currently does not control assets in Crimea
3. Naftogaz is a party to the contract with Gazprom on gas transmission
4. Naftogaz owns minority stakes in some of regional gas distribution and supply companies, except for Kirovohradgaz where Naftogaz owns 51% of shares
5. Naftogaz owns a minority stake

Annex 2: Privatisation process

- Public offering versus private placement?
- "Guidelines on Best Practice for the Audit of Privatisations" of the International Organisation of Supreme Audit Institutions (INTOSAI)

Annex 3

Composition of gas prices for Czech end-consumers



- Current shares of value generation in Ukraine gas sector quite different and subject to change