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REKK POLICY BRIEF

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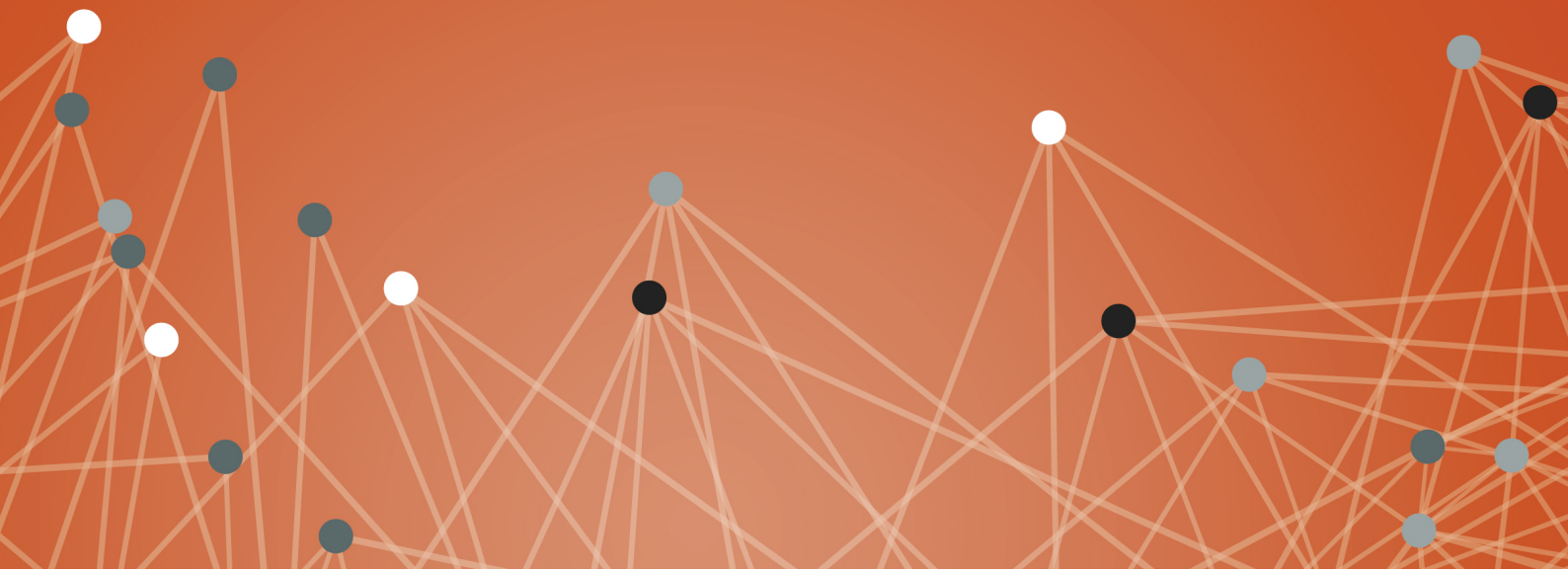


BORBÁLA TAKÁCSNÉ TÓTH - PÉTER KOTEK

REGIONAL VISION ON „CHALLENGES AND OPPORTUNITIES FOR UKRAINE GAS MARKET INTEGRATION - HOW CAN THE NEIGHBOURS CONTRIBUTE?"

Main conlcusions of the Central and South East Europe Energy Policy Forum

The Central and South East European Energy Policy Forum (CSEEPF), organized by the REKK Foundation, addresses a sensitive and timely energy policy topic every year. This year the topic was the future of the Ukrainian gas market and gas transit via Ukraine. The forum brought together leading government representatives, traders, storage and transmission system operators, think tanks and academics not only from Central and South East Europe but also from Western Europe and the US.

The discussion was organized along the natural gas value chain, with upstream, storage, transmission, trade and related regulatory developments addressed by distinguished speakers with valuable first-hand experience on the Ukrainian market. This paper summarizes the main conclusions of the conference with the aim to provide input for further actions within the CESEC initiative or any other initiative targeting Ukraine.

Participants agreed that Ukraine is at a crossroads and developments over the next two years will pave the way for Ukraine to either turn into a European Union accession country with common energy security challenges faced by other Central-Eastern EU Member states or become an instable state with continued economic, political and military problems. The future of the gas sector is strongly correlated with the political future of the country.

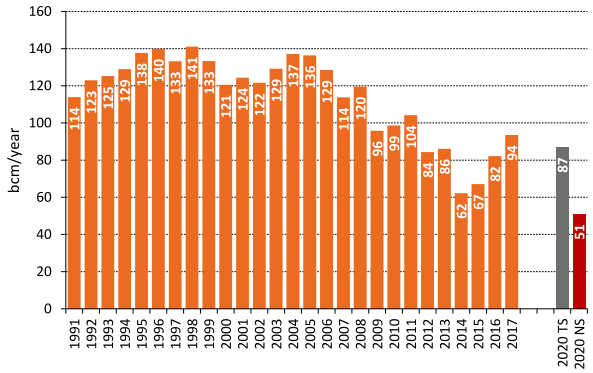
TRANSIT

Russian gas transit through the Ukraine was substantially curtailed between 2004 and 2014, falling from from 137 bcm/yr to 62 bcm/yr. Between 2015-2017 however the increased import need of the EU was flexibly supported by additional gas transit volumes arriving through Ukraine's existing pipeline network. This tendency will be altered with the commissioning of the first string of TurkStream and even further reduced if Nord Stream 2 comes online.

There was broad consensus that the European Union has both the economic, political and the security interest to keep Ukrainian transit flows. The future of Ukrainian gas transit has a significant effect not only on the Ukrainian gas market, but on the neighbouring Central and Eastern European economies as well. Participants agreed that the Nord Stream 2 project should not be considered only on a commercial basis.

The participants noted that the Stockholm Arbitration did not result in a renewal of bilateral trade between Russia and Ukraine as many hoped for. There was a broad consensus that **there is a role for the EU to play mediating between the parties**, as a mutual and balanced agreement on the supply and transit contracts and domestic reforms in Ukraine would be the most beneficial for all. Rebuilding trust to enable direct trade from Russia to Ukraine and the option of spot trade on the Ukrainian transmission system is by far the best outcome for all parties.

It was, however, also noted that **Ukraine should guarantee a stable legal environment to enable the most cost-effective route for transit. No political guarantee or support can substitute this basic pre-requisite.**



HISTORICAL AND MODELLED GAS TRANSIT FLOWS VIA UKRAINE
Source of figures: Naftogas data from 1991 to 2017, 2020 figures are based on REKK modelling

The following four scenarios for the future transit were identified and analysed by REKK and shared with the audience:

1. *There is no transit flow on Ukraine system after 2020, Ukraine is supplied on the reverse flow pipelines from the EU.*
2. *The long term contracts that are delivered in 2018 through Ukraine are still delivered through Ukraine, but the Ukraine route is not used to supply additional flexibility to Europe. Ukraine is supplied on the reverse flow pipelines from the EU.*
3. *The long term contracts that are delivered in 2018 through Ukraine are still delivered through Ukraine, and the Ukraine route is used to supply additional flexibility to Europe. Ukraine is supplied on the reverse flow pipelines from the EU.*
4. *The long term contracts that are delivered in 2018 through Ukraine are still delivered through Ukraine, and the Ukraine route is used to supply additional flexibility to Europe. Ukraine is supplied directly from Russia.*

The scenarios were tested on two infrastructure scenarios, one with Nord Stream 2 and recontracted LTCs as far as capacity allowed and another without.

In all scenarios calculations for the welfare of the European Union Members States, the profits of the Russian supplier and Ukrainian TSO, and Ukrainian social welfare were made. Results indicated that:

- *No transit via Ukraine is the worst outcome for EU welfare, the Ukrainian TSO and even Russian profits.*
- *If Nord Stream 2 is commissioned, Ukraine is not an attractive transit route for spot Russian deliveries; however,*
- *If NS2 is not in place, additional trade to Europe from Russia utilises the Ukrainian system to the benefit of all (like in 2015-2017)*
- *Renewal of direct trade from Russia to Ukraine might be the best outcome for all*

UPSTREAM

There is enormous potential in the upstream gas market of Ukraine. With the 4th largest gas reserves in Europe, the current level of production (around 20 bcm/year) could be easily increased. The Government of Ukraine's strategic target is to reach 27 bcm/year production level by 2020. To realize this goal, the regulatory environment has been streamlined, and the gas production royalties were reduced in the beginning of 2018.

Increasing domestic upstream production and improving energy efficiency to mitigate domestic gas demand were the overwhelming no-regret for Ukraine to lower its dependency on Russia and on gas transit. REKK modelling suggests that Ukrainian gas self sufficiency would secure a more stable welfare system and minimize exposure to any Russian alternative transit route strategy. With the **biggest opportunity in domestic gas production, it is important to unbundle gas production from Naftogaz**, equally as much as TSO unbundling.

UNBUNDLING OF TSO AND THIRD PARTY ACCESS

The participants expressed **disappointment with the stalled regulatory adaptation of the Third Package rules in Ukraine.** Although the impressive developments observed up until 2015 were appreciated, there was broad consensus that the adaptation of the rules remained on paper without clear indication of strong political commitment to move ahead with implementation of the rules.

The **unbundling of the transmission system operator** was identified as a prerequisite for any further development in the sector. Throughout the discussion the main areas of concern for unbundling were identified; the transit revenues are used by the state to fill gaps to cross subsidise cheap gas delivered to the household segment (60% of the consumers are under public service obligation) and the underlying issue of corruption and power of oligarchs prevent the TSO from collecting transit revenues. The obligation of Naftogaz to serve the district heating sector which is lacking accurate and transparent demand figures and heavily controlled by oligarchs that make inconsistent payments creates losses for the company. Without solving these underlying problems and **eliminating the subsidies** there is little chance for unbundling. The Gas Law in Ukraine only allows only for a form of ownership unbundling which lacks political support under the current conditions. Some participants suggested considering the revision of the approach to begin with smaller steps. There was a strong consensus for Ukraine to **start using the electronic platforms already developed for booking and nominations** as a first step to provide some transparency and ensure better third-party access to the network.

The current high level of transmission tariffs further discourages transit through Ukraine relative to potentially more competitive alternative routes, and yet the reduction of these tariffs alone might not be enough, rather neighboring TSOs on the route should also consider tariff revision to keep the Ukrainian transit route open or also risk losing their transit.

STORAGE

The Ukrainian storage market offers a great possibility for gas companies. There are large storage facilities with very low tariffs compared to storage fees in neighbouring EU countries. Unfortunately, regulation has limited the sale of gas stored in Ukraine to the territory of Ukraine. To allow for more open regional and commercial use of storages in Ukraine, **this regulation needs to be changed and transmission tariffs on Ukrainian exit points published.** Use of storage would be enabled by **exact and transparent rules for balancing.** The current ad hoc practice of balancing does not help traders to manage their own risks.

REGIONAL INFRASTRUCTURE INVESTMENT PLANS

The recent reverse flow investments are a remarkable success, and the result of regional cooperation that had a massive impact on the gas markets not only in Ukraine but in other surrounding EU Member States in Central and Eastern Europe as well. The speakers and participants emphasised the future plans for further reverse flow projects. Heads of neighbouring TSOs agreed that despite ambitious plans, **there is limited need for new interconnectors and the current infrastructure should be better utilized by implementing the regulations already adopted.**

A large majority of the participants agreed that the future of the gas transit through Ukraine is determined by the Russian infrastructure investments and Ukraine has limited options to influence this. Participants suggested that Ukrainian regulation should implement the measures that are available before it is too late:

- Focus on attracting investment into upstream gas production; unbundling of gas production is key
- Ensure third party access to the grid in a transparent manner and start using the electronic platform for nominations and booking
- Set transmission tariffs lower to encourage trade, upstream and storage
- Eliminate subsidies in the retail segment and implement the unbundling of the TSO

AUTHORS

Borbála Takácsné Tóth has worked with REKK since its creation in 2004. In 2001 she received an M.A. in International Relations and European Studies at the Central European University in Budapest. Borbala was educated as an economist and received her degree from the Budapest University of Economic Sciences in 1998. She spent 5 years as a civil servant in government administration mostly in the field of energy regulation. Between 2001 and 2003 she was Head of the President's Secretariat responsible for international relations of the Hungarian Energy Office. In this capacity she worked closely with ERRA and CEER. With REKK she has been leading several international and national consultancy projects, with many using the European Gas Market Model as the primary analytic tool. Her main fields of expertise include: regional co-operations; security of supply issues; energy geopolitics; major infrastructure initiatives in the gas sector and incentives for investments; competition cases in the gas market; and the effect of gas release programs on competition in the gas market in Europe.

Péter Kotek graduated in 2009 at the Corvinus University of Budapest as an economist, majoring in market analysis. He joined REKK in the same year as a research associate. From 2015, he is working as a senior research associate. His areas of interest are ancillary services market in electricity, LNG and gas storage markets regarding gas markets.

REKK FOUNDATION

The goal of the REKK Foundation is to contribute to the formation of sustainable energy systems in Central Europe, both from a business and environmental perspective. Its mission statement is to provide a platform for open-ended, European-wide dialogue between government and business actors, infrastructure operators, energy producers and traders, regulators and consumers, professional journalists and other interested private entities. The REKK Foundation develops policy briefs and issue papers with forward-looking proposals concerning challenges posed by energy and infrastructure systems and organizes regional forums allowing stakeholders to become familiar with the latest technological and regulatory developments within the industry.

Further information: www.rekk.org

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