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Ukraine: Naftohaz Restructuring in Question

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Ukraine has started reforming its gas sector simultaneous with its struggle against Russian aggression and trying to prevent the construction of the Nord Stream 2 gas pipeline, which would deprive the country of most of its current gas transit revenues. However, further reforms are hampered by the lack of political will among Ukrainian authorities. The slow pace of the reforms and a dispute between the government and management of Naftohaz have negatively affected Ukraine's international image. These factors could lead to a situation in which gas transit via Ukraine no longer is considered a viable alternative to the new Gazprom pipelines, which would seriously undermine Poland's diplomatic efforts in support of Ukraine's opposition to Nord Stream 2.

The Importance of Reform of Naftohaz. Reform of state monopolist Naftohaz and related changes in the gas sector are some of the most difficult and, at the same time, most important ones the Ukrainian authorities have ever initiated. The reform is required primarily because of Ukraine's severe economic problems. In 2014, the Naftohaz deficit covered from the state budget amounted to more than 6% of the country's GDP and, when combined with the economic crisis that has lasted since 2012, has shaken Ukraine's macroeconomic stability. To cover this gap, in 2014–2015 the country's authorities were twice forced to seek financial assistance from the International Monetary Fund (IMF). Restructuring the company then became one of the IMF's main conditions of the loans.

Naftohaz reform is also of key political importance. For years, Ukraine was dependent on the import of Russian gas, which allowed Russia to influence every Ukrainian government that followed, such as tying gas supplies to political issues (e.g., agreements on military bases in Crimea),[1] and which favoured links between Russian and Ukrainian elites, enabling them to derive illicit revenues from the gas trade. The corruption led to an inefficient economy in Ukraine and further deepened its dependency on Russia. The suspension of gas imports from Russia in autumn 2015 limited its influence on Ukraine but did not eliminate all the problems in the gas sector.

Key Points of the Reform. Naftohaz is Ukraine's largest enterprise in the energy sector and, together with subordinated entities, is the largest taxpayer in the country. The company deals with a wide range of activities, including gas extraction, storage, and transportation. According to the restructuring plan adopted by the Ukrainian government in July 2016 and based on requirements of the EU's "third energy package," Naftohaz will be unbundled, that is, various segments will have new ownership. Naftohaz will give up gas pipelines and underground storage facilities to two new, separate companies subordinated to the Ministry of Energy and Coal Industry. The move is aimed at the creation of a transparent and competitive gas market and, consequently, attracting foreign direct investors. Among those interested in maintaining gas transit

[1] J. Ćwiek-Karpowicz, "Russia-Ukraine Agreements on Black Sea Fleet Stationing and Preferential Gas Prices," *PISM Bulletin*, no. 62 (138), 23 April 2010.

through the territory of Ukraine are operators from Italy and Slovakia, which may assist in the future with modernisation of the Ukrainian gas network.

Another important element of Naftohaz reform is liberalisation of the gas price for households. Maintaining the state-regulated prices at below market levels has led to a gradual increase in the company's debt, which was then covered by the state. A regular review of the household gas price was another IMF requirement. Between 2014 and 2017, the government increased the price for individual customers almost tenfold, but it remains lower than the market price, which results in inefficient gas consumption and corruption, since sales take place through intermediaries that do not provide information on gas consumption and its actual recipients. Naftohaz estimates that this system generates losses of about €1.3 billion per year.

Naftohaz Restructuring Problems. The recent improvement in the financial condition of Naftohaz and its subsidiaries—in 2017, Naftohaz paid almost €3 billion in taxes and dividends, amounting to almost 14% of the country's budget revenues—has again heated up the battle for control over the company's financial streams. In 2016, the Ministry of Economic Development and Trade tried to seize control of Ukrtranshaz, one of Naftohaz's most profitable subsidiaries, responsible for gas transit and storage. The move went against the Naftohaz restructuring plan agreed with the Energy Community and European Bank for Reconstruction and Development (EBRD), and against an agreement for financial help from the bank. In the end, the decision was repealed after the international financial institutions threatened to halt the financial support for Ukraine.

The Ukrainian government also has attempted to take backdoor control of Naftohaz. In spring 2017, the government increased the number of supervisory board members from five to seven, thus gaining a majority on the board. In protest, two of the remaining independent members of the board resigned (another had already resigned). Under international pressure, the government in November 2017 accepted a new board with a majority composed of independent members.

The restructuring also has fallen victim to a dispute between the government and Naftohaz management, who accuse each other of attempts to sabotage the unbundling. The government has delayed the establishment of the new entity responsible for the gas-transmission system. Naftohaz has instead created its own new branch responsible for this within Ukrtranshaz. The company also has enlisted Rothschild & Co., a financial advisory firm, to help with the restructuring and finding foreign investors. In response, the government blocked Naftohaz from negotiating with foreign investors.

The unbundling also has been halted by a dispute between Naftohaz and Gazprom and now in a Stockholm arbitration court. According to the restructuring plan, the new enterprises with Ukrtranshaz assets will start operation after the final verdict. The ruling is very important for foreign investors because of mutual multi-billion-dollar claims. The court's ruling from December 2017 is generally favourable for Naftohaz (e.g., Gazprom's multi-billion-dollar claims were rejected), although the court still required Ukraine to repay around $2 billion in debt. The last in the series of verdicts is expected at the end of February.

Perspectives. The Stockholm tribunal's final verdict will clear the way for Naftohaz unbundling. However, the Ukrainian authorities seem to lack the political will to finish the restructuring. Their grip on the financial streams within Naftohaz and its companies will play a significant role in the campaign ahead of the 2019 presidential and parliamentary elections. It is also unclear whether the government allow another gas price increase for households, fearing a loss of voter support. On the other hand, continuing the Naftohaz restructuring is essential to further support for Ukraine from international financial institutions.

The favourable arbitration ruling and the possibility to gain additional financing from the financial market could paradoxically weaken the government's push for reforms. Further disputes with Naftohaz management may also discourage foreign partners from investing in the Ukrainian transmission system.

From Poland's perspective, the restructuring of Naftohaz and the Ukrainian gas sector reforms—necessary to maintaining Ukraine's international credibility—are a crucial argument against the Nord Stream 2 pipeline. Ukraine was able to ensure stable transit of Russian gas through its territory even when faced with Russian military aggression in the east. Thus, it is reasonable to demand that Ukraine does not waste this asset. Predictability in Ukrainian energy policy and transparency in its gas market are also crucial for joint projects, including the Poland-Ukraine gas interconnection.