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Analyst's Notebook

Ukraine/Energy
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****Editor's Note:** In order to keep our coverage of the Ukrainian market as up to date as possible Concorde Capital is launching a new product – Analyst's Notebook. Unlike our more in-depth desk notes and reports, Analyst's Notebook provides rapid feedback on breaking news in the Ukrainian market. Analyst's Notebook gives you our analysts' first impressions of a situation and may set the table for further investigation. Our analysts will use their experience in their sectors to take a look at the situation and provide insight or speculate on possible scenarios. We want to emphasize however, this product consists mostly of the analyst's intuition and may require further analysis.

The Gas Crisis: Good For Electricity Companies?

In a nutshell: The jump in gas prices is music to the ears of Ukraine's electricity companies. For the most part indifferent to gas price growth, Ukraine's coal-fueled power plants can take advantage of the gas crisis. The switch from expensive gas to less expensive electricity consumption will benefit GenCos and Oblenergos.

Electrification instead of gasification?

Gas price growth makes the future development of gas distribution networks in Ukraine look bleak, leaving the door open for electricity to begin substituting gas in households. An electricity-for-gas substitution program will increase the load of generation companies (including the coal fueled power units of thermal power plants, which are under-utilized), and lead to a decrease in their production costs, boosting profitability. Distribution companies will also win.

Electricity consumption potential: long term - households

Nearly 20% of Ukraine's households use bottled liquid gas, and are waiting for the gasification of their dwellings. Energy companies have started proposing the use **electricity** for cooking and local heating, which would lead to an increase in electricity consumption. Reaching a 100% penetration of gas networks Ukraine would increase household gas consumption by 2 bcm. The equivalent amount of electricity needed to substitute this quantity of gas is 18.5 TWh (13.5% of Ukraine's total annual consumption). In the long term, if households currently using gas substitute ½ of their gas (or 7.5 bcm) for electricity, this alone would increase the total demand for electricity by 50%.

Short term: budget sector consumption

Enterprises in the budget sector (government buildings) use 1 bcm of gas annually for heating. If the electrification-instead-of-gasification project becomes nation-wide (as we expect in 2006) these organizations will be the first to shift from gas to electricity in 2006-2007. The government is running an experiment on this issue in Donetsk region.

Do energy companies promote electricity consumption growth?

Yes, the management of most Oblenergos we have met with stress that they promote the substitution of electricity for gas, especially in the locations which have not yet been gasified (and now probably never will). Additionally, Oblenergos promote/lobby for the installation of electric heating and cooking devices in newly constructed buildings.

Are Ukrainian networks capable of handling electricity load growth?

Not entirely. While most Oblenergos have unused potential today, electricity networks in houses built in Soviet times were not designed for today's modern electric appliances. Thus, in addition to electricity use promotion, Oblenergos need to invest in upgrading local networks. There are forces inside the NERC (responsible for Oblenergo CapEx approval) pushing for an electricity to gas substitution, therefore we expect an increase of CapEx for this purpose. The main source of CapEx, as usual, will be an increase to distribution companies' tariffs.

How fast would electricity consumption grow?

If Oblenergos and the state succeed in promoting electricity instead of gas (taking into account the deficit of cheap gas and excess electricity supply, this has a high probability), we estimate that the substitution of gas for electricity will boost electricity demand by 2% in both 2006 and 2007, and by about 4-6% in 2008-2012. In rural regions (all the western regions) the growth rate would be higher.

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