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Analyst's Notebook

Ukraine/Oil&Gas
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Ukraine To Protect Local Gas Market: Will It Succeed?

In a nutshell: On March 9, 2006, the National Electricity Regulation Commission (NERC) granted Ukgaz-Energo, a JV created by RosUkrenergo and Naftogaz Ukrayiny, a 5-year license to supply 5 bln cm of natural gas a year to domestic consumers at an unregulated tariff. The license enables Ukgaz-Energo to sell only 5 bln cm of its yearly plan of 34 bln cm to the Ukrainian market with discretionary supply charge. The restriction was motivated by Ukrainian Antimonopoly legislation: a company's share in the gas market should not exceed 35%.

What's the problem? According to the agreement between Naftogaz Ukrayiny, Gazprom and RosUkrEnergo (RUE) Ukgaz-Energo contracted 34 bln cm from RUE. That amount of gas was supposed to be sold by Ukgaz-Energo to the Ukrainian market.

The 5 bln cm restriction contradicts the January's agreement, as the latter directly assumed that 34 bln cm is to be sold by RosUkrEnergo to Ukgaz-Energo at USD 95 per ths cm, **AND** this amount is to be supplied by Ukgaz-Energo to domestic market.

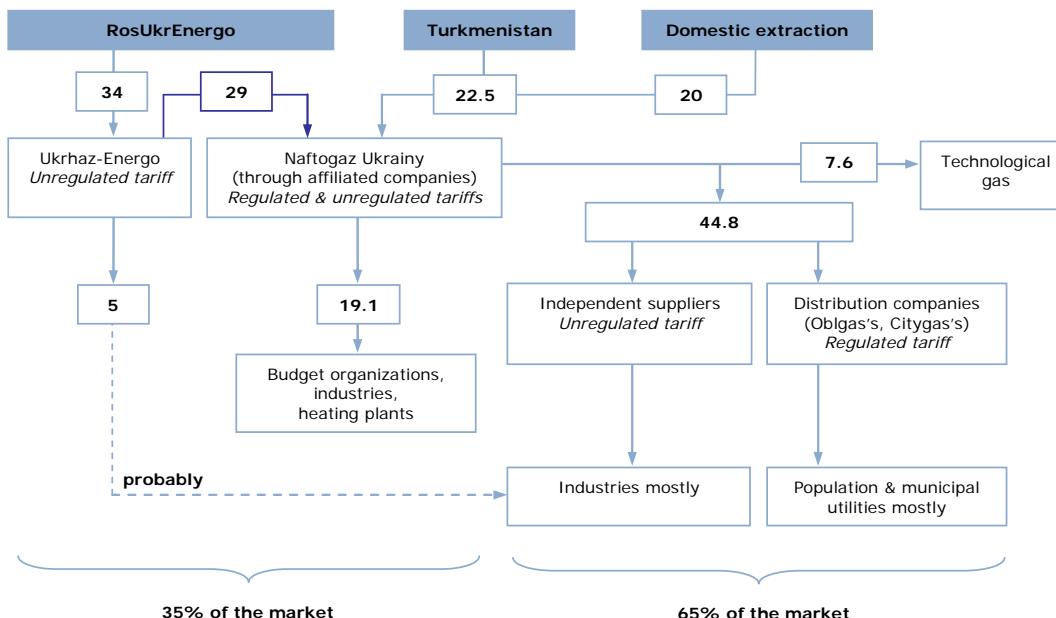
Look for the gas issue to flare-up again soon. In our opinion, the violation of the contract terms may result in the revival of gas tensions between Russia and Ukraine.

We expect Ukgaz-Energo to supply gas until the 5 bln cm limit is reached -- then the parties will start re-negotiating.

These negotiations may result in Ukgaz-Energo reselling the leftover gas, 29 bln cm, to Naftogaz Ukrayiny (see the scheme below). Alternatively, they may decide that RosUkrEnergo will supply gas to Naftogaz directly, bypassing Ukgaz-Energo. In any case Ukgaz-Energo would suffer. If it sells gas to Naftogaz instead of final consumers, it would lose in terms of profitability. If RUE supplies gas directly to Naftogaz, the latter would lose 85% of its gas sales. Moreover, in both cases Ukgaz-Energo would be deprived of access to the local gas market – Gazprom and other RUE owners would definitely be upset. In revenge, Russia may threaten ratchet up gas prices once again.

WATCH: Russian's response.

Hypothetical scheme of gas consumption to the domestic market (billions cubic meters)



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