



CONCORDE CAPITAL

# Ukraine / Oil & Gas Gas Issue

## The Last Battle Over Transit?

October 4, 2007

Vladimir Nesterenko  
+380 44 391 5577  
vn@concorde.com.ua

### Ukraine's gas balance, 2006

Extraction	20.7	27%
Imports*	56.9	73%
<b>Total supplies</b>	<b>77.6</b>	<b>100%</b>
Industry	33.0	45%
- energy	8.7	
- metallurgy	9.3	
- other	10.2	
Population	19.9	27%
MHE**	13.0	17%
Technological use	8.1	11%
<b>Total consumption</b>	<b>73.9</b>	<b>100%</b>
Transit balance	3.8	

\* All imports of gas to Ukraine are sourced through RosUkrEnergo

\*\* Municipal heating enterprises

Source: *Energobusiness*

### Major transit countries for Russian gas, 2006

Ukraine	121.5	75%
Belarus	40.0	25%
Total	161.1	100%

Source: *Energobusiness, Gazprom*

### Gazprom gas exports, 2006

Europe	161.5	62%
- Germany	34.4	
- Italy	22.1	
- Turkey	19.9	
- Other	85.1	
CIS & Baltic states	101.0	38%
- Ukraine*	59.0	
- Belarus	20.5	
- Other	21.5	
Total	262.5	100%

\* Through RosUkrEnergo, the data may differ from Ukraine's gas balance above due to different treatment of gas pumped into storages

Source: *Gazprom*

**Gazprom's claim that Ukraine allegedly owed a USD 1.3 bln gas debt marked the start of this year's gas negotiations. We expect tough talks given Russia's designs on Ukraine's transit pipeline and the fact that there is only one opportunity for a large price increase: small increments won't do the job. In our most likely scenario, formation of an 'orange' coalition means another gas price hike. The good news is that businesses are now better prepared for an increase than two years ago. The few potential victims include fertilizer producers, Kyivenergo and Zaporizhstal.**

### Gazprom demands Ukraine clear USD 1.3 bln debt. What debt?

Yesterday Gazprom announced that Ukraine's gas debt had reached USD 1.3 bln, and demanded settlement. This is Ukraine's largest gas debt ever, and we believe the overdue amount should not exceed half of that. Assuming Naftogaz's reported USD 300 mln payables as of 2Q07 is reliable, the alleged four-fold increase would mean Naftogaz paid nothing for gas in 3Q07, which is unlikely. The Ukrainian government has not publicly confirmed the amount, but promised to clarify the issue with Gazprom and repay all debt by the end of October. We consider this announcement as signaling the start of another round of gas negotiations, rather than a stand-alone issue.

### Probably the last battle for the pipeline has begun

The development of Ukraine-Russia gas relations over recent years, Russia's gas strategy vis-à-vis Europe, and problems with its Nord Stream project suggest that Ukraine might be on the eve of its final battle for the transit pipeline. Last year Ukraine was able to get a gas price discount by giving up a significant portion of its gas distribution sector. This year there is little to offer, except the pipeline, control over which would significantly enhance Russia's geopolitical power in the region.

Gazprom can easily raise gas price for Ukraine by more than 50% to USD 200-230/tcm, and we doubt Russia will miss the chance to exercise its leverage. Smaller increases just won't work. We have three scenarios:

- **Hostile (probability: 50%).** Our Ukraine and BYT form a coalition. Russia threatens to boost gas prices; it may also demand immediate repayment of debts, cut supplies, and use all other possible means to ensure maximum leverage in transit talks. If the coalition government gives up the pipeline, the price increase will be insignificant. More likely it won't and Ukraine will face a substantial price increase in the short-term.
- **Stand-by (probability: 30%).** A coalition is not formed by yearend. In this scenario, supply cuts are most possible, as no coalition will mean no agreement on supply volumes and prices for 2008.
- **Friendly (probability: 20%).** Pro-Russian forces form a parliamentary coalition in Ukraine. Russia reduces pressure, comfortable that friendly forces are in power, which have less fear of Russian leverage and are more likely to give up control of gas transit. Gas price increases are smoother, USD 140-160/tcm remains the most likely scenario for 2008.

### Potential victims

We did expect a moderate gas price increase next year to USD 140-160/tcm. A higher price will affect fertilizer stocks, Kyivenergo (the only listed electricity generator with significant gas exposure) and Zaporizhstal (steel producer most reliant on open-hearth technology, making it more dependent on gas). For other sectors, the increase will be relatively less painful. Steel makers are generally prepared to shift to coal-injection technology, and power generators already reduced their gas usage by two to three times.

**Concorde Capital**  
 2 Mechnikova Street  
 21st Floor  
 Kyiv 01601, UKRAINE

**Tel.: +380 44 391 5577**  
**Fax: +380 44 391 5571**  
**www.concorde.com.ua**  
**office@concorde.com.ua**

**CEO**

Igor Mazepa

im@concorde.com.ua

**RESEARCH COVERAGE BY SECTOR**

**Head of Equity Sales**

Lucas Romriell

lr@concorde.com.ua

**Strategy**

Konstantin Fisun  
 Oleksandr Klymchuk

kf@concorde.com.ua  
 ok@concorde.com.ua

**Equity Sales**

Marina Martirosyan  
 Anastasiya Nazarenko  
 Duff Kovacs, CFA  
 Zack Watson

mm@concorde.com.ua  
 an@concorde.com.ua  
 dk@concorde.com.ua  
 zw@concorde.com.ua

**Metals & Mining**

Eugene Cherviachenko

ec@concorde.com.ua

**Utilities (Telecom, Energy)**

Alexander Paraschiy

ap@concorde.com.ua

**Director of Research**

Konstantin Fisun, CFA

kf@concorde.com.ua

**Oil & Gas, Chemicals**

Vladimir Nesterenko

vn@concorde.com.ua

**Consumer/Retail Group**

Andriy Gostik, CFA  
 Olha Pankiv  
 Alexander Romanov  
 Anna Dudchenko

ag@concorde.com.ua  
 op@concorde.com.ua  
 ar@concorde.com.ua  
 ad@concorde.com.ua

**Machinery**

Olha Pankiv  
 Eugene Cherviachenko  
 Inna Perepelytsya

op@concorde.com.ua  
 ec@concorde.com.ua  
 pi@concorde.com.ua

**Financial Services, Retail**

Alexander Viktorov

av@concorde.com.ua

**Macroeconomics**

Alexander Viktorov  
 Polina Khomenko

av@concorde.com.ua  
 pk@concorde.com.ua

**Fixed Income**

Oleksandr Klymchuk

ok@concorde.com.ua

**Corporate Governance**

Nick Piazza

np@concorde.com.ua

**News/Production**

Nick Piazza  
 Polina Khomenko

np@concorde.com.ua  
 pk@concorde.com.ua

**Editor**

Brad Wells

bw@concorde.com.ua

---

**Disclaimer**

This report has been prepared by Concorde Capital investment bank for informational purposes only. Concorde Capital does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that Concorde Capital might have a conflict of interest that could affect the objectivity of this report.

Concorde Capital, its directors and employees or clients might have or have had interests or long /short positions in the securities referred to herein, and might at any time make purchases and/or sales in them as a principal or an agent. Concorde Capital might act or has acted as a market-maker in the securities discussed in this report. The research analysts and/or corporate banking associates principally responsible for the preparation of this report receive compensation based upon various factors, including quality of research, investor/client feedback, stock picking, competitive factors, firm revenues and investment banking revenues.

Prices of listed securities referred to in this report are denoted in the currency of the respective exchanges. Investors in financial instruments such as depository receipts, the values or prices of which are influenced by currency volatility, effectively assume currency risk.

Due to the timely nature of this report, the information contained might not have been verified and is based on the opinion of the analyst. We do not purport this document to be entirely accurate and do not guarantee it to be a complete statement or summary of available data. Any opinions expressed herein are statements of our judgments as of the date of publication and are subject to change without notice. Reproduction without prior permission is prohibited. © 2007 Concorde Capital