CONCORDE CAPITAL

Ukraine / Oil & Gas

Gas Issue

Price double ahead, Should be the last

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

- **Russia's Foreign Minister said last Friday that Ukraine will see a twofold gas price hike next year, instigated by more expensive Central Asian gas**
- **This exactly meets our forecast from March. We stick to our upper case forecast for the 2009 import price: USD 320/mcm at the border (+78% yoy); convergence to the 'market level' should complete by 2010**
- **NATO accession is unlikely to be politically sacrificed for a price discount**
- **Most negative for Kyivenergo (KIEN: HOLD) and Naftogaz of Ukraine. Most positive for gas-focused E&Ps: JKX Oil & Gas (JKX LN: N/R), Regal Petroleum (RPT LN: N/R), Cadogan Petroleum, etc.**

Ukraine's gas consumption* '07, bcm

Industry	34.2	48%
- energy	8.4	
- metallurgy	9.8	
- other	16.0	
Population and Budget enterprises	17.9	25%
MHE**	10.5	15%
Technological use	8.5	12%
Total consumption	**71.1**	

* *See also the scheme on the next page*
** *Municipal heating enterprises*

Source: Energobusiness

Domestic gas prices*, USD/mcm

	2007	**2008
Imports	130.0	179.5
Population***	52.0 - 212.9	
MHE	113.2	
Budget enterprises	142.6	185.1
Industry	142.6	185.1

* *Net of VAT, charges, distribution and other costs, except prices for MHE and the population, which include the abovementioned items*
** *As of March*
*** *Differentiated by category of consumer*

Source: Gas of Ukraine

Russian minister says gas price for Ukraine will double in 2009

The gas price for Ukraine will almost double in 2009, as a result of Russia switching to market pricing for Central Asian gas, Russia's Foreign Minister Serhey Lavrov said following last Friday's meeting between the Russian and Ukrainian presidents. According to Lavrov, Viktor Yushchenko told Dmitry Medvedev that Ukraine is also interested in shifting to market prices as soon as possible.

USD 320/mcm at the border, USD 425-450/mcm for the industry

The announcement meets our forecast from March of this year, both in terms of magnitude and reasoning. We keep our forecast for the 2009 import price unchanged at USD 320/mcm (+78% yoy). We also project Ukraine's border price to converge with the European netback price at ~USD 370/mcm in 2010, a year earlier than declared in Gazprom's strategy.

We forecast prices for the industry, implied by the expected increases in the import price at USD 424-452/mcm for 2009 and USD 482-520/mcm in 2010 - around twofold cumulative growth in two years.

NATO appears a clear priority over gas price

News of the price hike came on the back of Russia's strengthening political pressure on Ukraine in regards to its NATO ambitions, and flaring tensions within the parliamentary coalition. One of the points in our March report was that Ukraine could limit the increase if it softens its position on NATO accession. We still believe this could help, but Lavrov's announcement smells like NATO is a higher priority for Yushchenko.

Winners and losers

Among listed stocks, we expect *Kyivenergo* to be affected the most, while nitrogen fertilizer producers seem to have a chance to land softer thanks to their unregulated and rapidly growing product prices. *Naftogaz of Ukraine*, which is already facing a liquidity challenge, is likely to see a further strain on its working capital, as the company covers the least solvent customers.

On the other side, natural gas producers like *JKX Oil & Gas* and *Regal Petroleum* should benefit from higher gas price realizations. This is also good news for *Cadogan Petroleum*, which is planning to hold an IPO later this year. The effect on *Ukrnafta* (UNAF: SELL) will only be positive if the government removes price capping for partnerships with the state. We see more pressure on the trade balance and support for the UAH/USD exchange rate next year.

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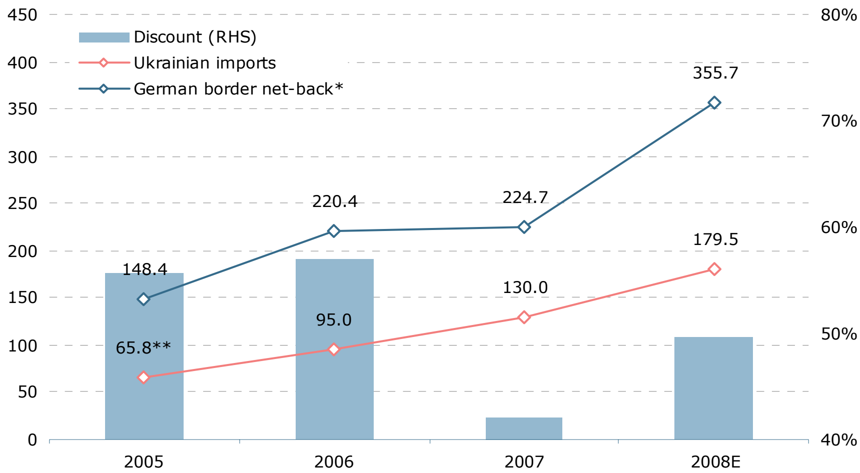
Why does 'market pricing' mean a twofold hike?

Even after Ukraine's price for gas almost tripled over 2005-08, the country is still buying gas twice cheaper than the market price, which we define as the German wholesale spot price, netted back to the Ukrainian-Russian border, assuming transportation costs at USD 60 per thousand cubic meters (mcm).

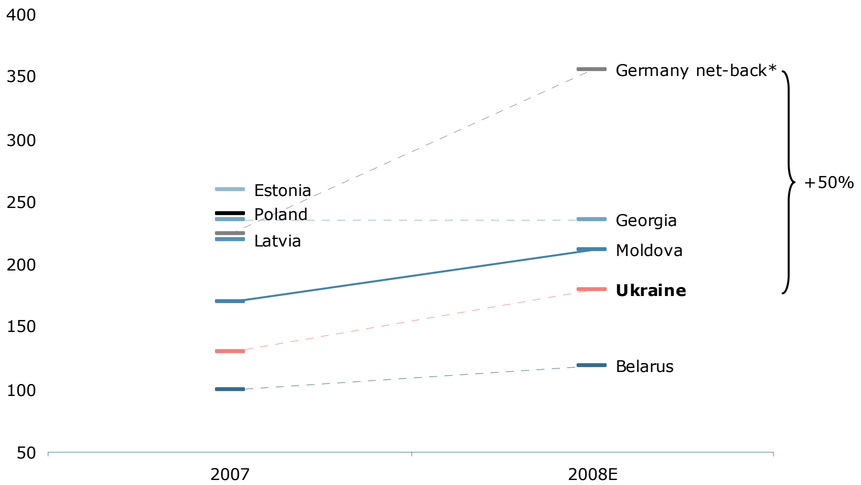
Yearly average gas price at Ukrainian-Russian border, USD/mcm



** Average contract price at German border, netted back to the Ukrainian-Russian border (assuming total transportation costs at USD 60/mcm)*
*** Weighted average of the prices paid to Gazprom and Turkmenistan. This was the last year of direct gas supplies from Turkmenistan*
Source: Ministry of Fuel and Energy, Oxford Institute for Energy Studies

In 2007, Belarus was the only CEE/CIS nation to receive cheaper gas than Ukraine. Georgia, Moldova, Baltic and CEE countries paid a 30%-100% premium over Ukraine's price.

Comparison of border prices, USD/mcm

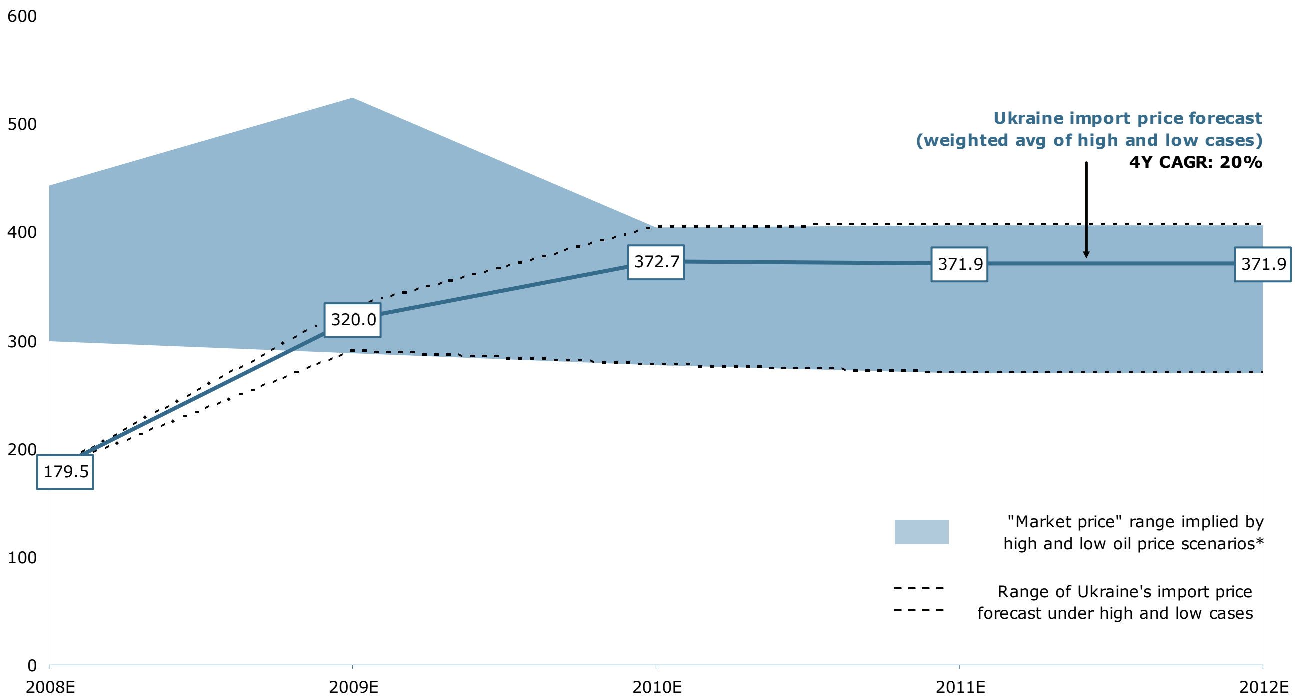


** Average contract price at German border, netted back to the Ukrainian-Russian border (assuming total transportation costs at USD 60/mcm)*
Source: Gazprom, Oxford Institute for Energy Studies

We forecast the gas price at the Ukrainian-Russian border to grow by roughly 78% next year; convergence to the market level should be completed by 2010-2011.

In our model, the size of the increase and rate of convergence depend on two key parameters: the level of the future market price (forecast based on oil price projections) and ability of Central Asian suppliers to effectively bargain for higher prices. To capture these uncertainties, we employ scenario analysis, which yields two cases for Ukraine's border price. We give more weight to the 'high' case to factor in our bullish view on global oil prices and growing sellers' power.

Projected gas price netbacks to Ukrainian-Russian border, USD/mcm



** "High" oil scenario: USD147/bbl on average in 2008, USD 171 in 2009, and USD 135 in 2010; "low" scenario: USD 105, USD 101, USD 98, respectively*
Source: Bloomberg, Concorde Capital estimates

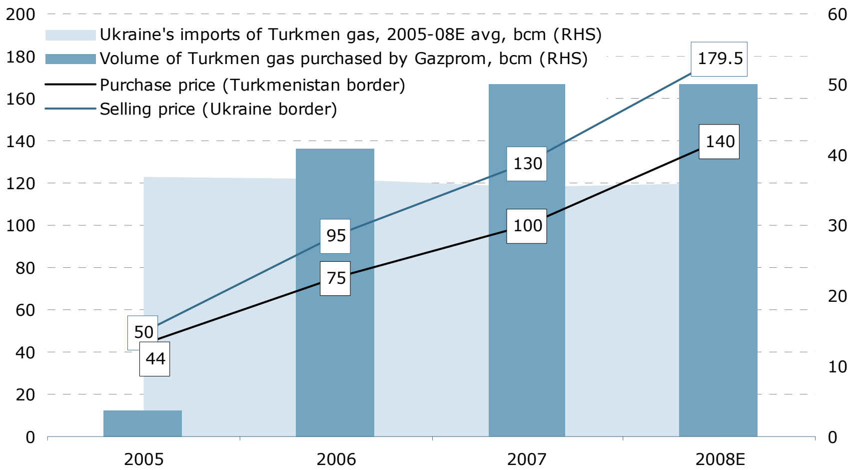
Sellers' power is getting stronger

In March 2008, the presidents of Turkmenistan, Kazakhstan and Uzbekistan, held a joint meeting with Gazprom's management to bargain for higher gas prices. In a statement following the meeting, the parties said they agreed on 'market pricing' from 2009. We perceive the visit as evidence of a collusion to raise the price Central Asian suppliers get from Gazprom to the level implied by European market prices (see our report from March 12, 2008).

Currently, Central Asian suppliers (Turkmenistan being the largest with ~75% share – see the scheme in the Appendix) are bearing opportunity cost on their gas sales to Gazprom. For example, we estimate that Turkmenistan loses roughly USD 200 on every mcm sold to Gazprom, the opportunity loss exceeding even the selling price itself.

On the other hand, Gazprom is targeting long-term control over Central Asian gas, as Russia has no substitute for those sources. Gas supplies are perhaps the only tool powerful enough to secure Russia's influence over Ukraine and other CIS countries. To keep its dominance on both sides of the pipeline, Gazprom is in fact balancing what sellers want and what Ukraine can afford. With sellers' pricing power getting stronger, the convergence should happen sooner rather than later.

Gazprom purchase price vs. selling price for Ukraine, USD/mcm



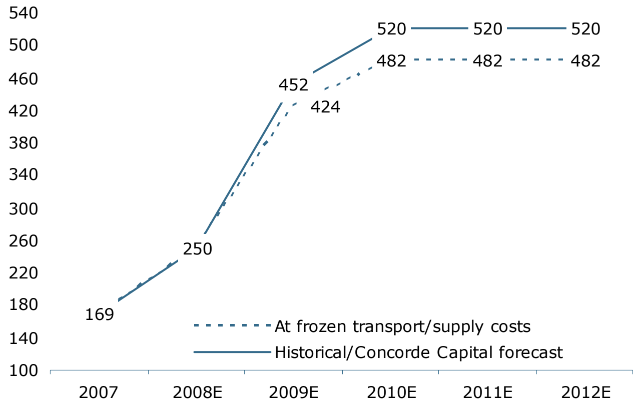
Source: Gazprom, Energobusiness

2009 price for industrials: USD 424–452/mcm

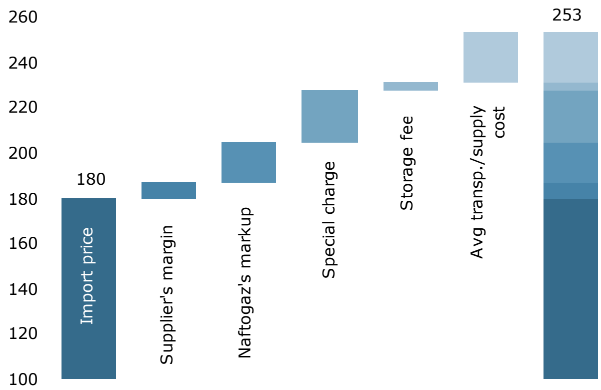
We estimate that under an import price of USD 320/mcm, Ukrainian industrial consumers will pay at least USD 424/mcm, of which around USD 30 is the wholesalers' cumulative markup, USD 40 is the so-called 'special investment charge', and USD 34 is the storage/transportation/supply cost.

Gas prices for industrials, ex-VAT, USD/mcm

Annual average forecast

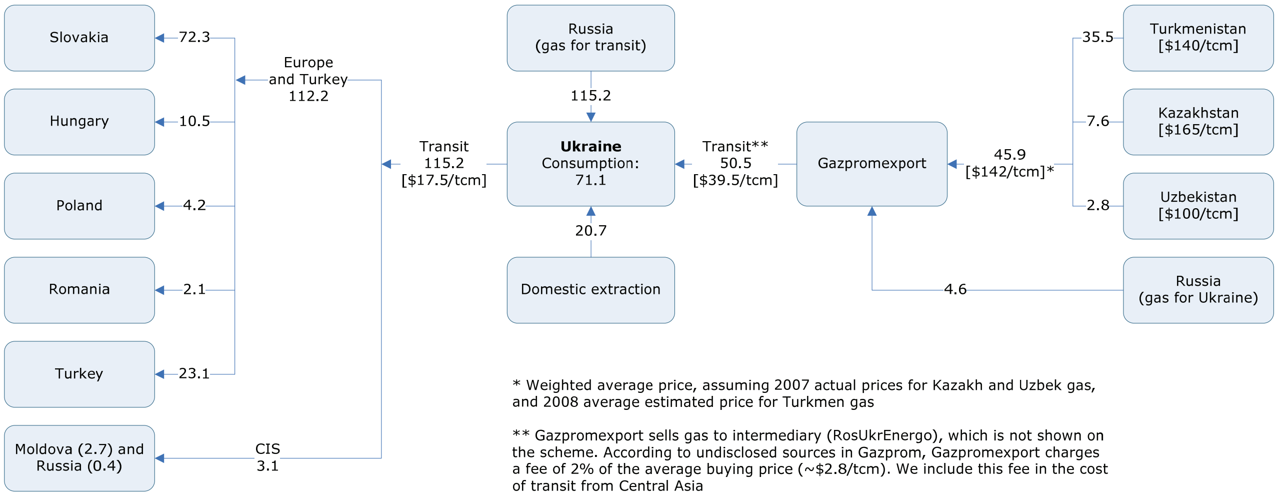


Price decomposition as of today



Source: Naftogaz of Ukraine, National Electricity Regulatory Commission, Gazprom, Energobusiness

Appendix. Ukraine’s gas sources and transit in 2007, bcm



* Weighted average price, assuming 2007 actual prices for Kazakh and Uzbek gas, and 2008 average estimated price for Turkmen gas

** Gazpromexport sells gas to intermediary (RosUkrEnergo), which is not shown on the scheme. According to undisclosed sources in Gazprom, Gazpromexport charges a fee of 2% of the average buying price (~$2.8/tcm). We include this fee in the cost of transit from Central Asia

Source: Energobusiness, Gazprom, Naftogaz of Ukraine, media

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

Head of Equity Sales
Roman Nasirov rn@concorde.com.ua

Equity Sales
Anastasiya Nazarenko an@concorde.com.ua
Duff Kovacs, CFA dk@concorde.com.ua
Marina Martirosyan mm@concorde.com.ua
Andriy Supranonok sap@concorde.com.ua

Director of Research
Konstantin Fisun, CFA kf@concorde.com.ua

RESEARCH COVERAGE BY SECTOR

Strategy
Konstantin Fisun kf@concorde.com.ua
Oleksandr Klymchuk ok@concorde.com.ua

Metals & Mining
Eugene Cherviachenko ec@concorde.com.ua
Andriy Gerus ga@concorde.com.ua

Utilities (Telecom, Energy)
Alexander Paraschiy ap@concorde.com.ua

Oil & Gas, Chemicals, Pharmaceuticals
Vladimir Nesterenko vn@concorde.com.ua

Real Estate/Construction
Andriy Gostik, CFA ag@concorde.com.ua
Alexander Romanov ar@concorde.com.ua

Consumer-related
Olha Pankiv op@concorde.com.ua
Anna Dudchenko ad@concorde.com.ua

Machinery
Eugene Cherviachenko ec@concorde.com.ua
Inna Perepelytsya pi@concorde.com.ua

Financial Services, Retail
Alexander Viktorov av@concorde.com.ua

Macroeconomics
Polina Khomenko pk@concorde.com.ua

Fixed Income
Oleksandr Klymchuk ok@concorde.com.ua

Editor
Brad Wells bw@concorde.com.ua

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