UKRAINE
Oil & Gas

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CONCORDE CAPITAL

How Much Is The Gas?

Short-Term Price Outlook

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Summary

Gazprom Agrees To Pay $35/tcm More for Turkmen Gas
Gazprom announced yesterday that it had agreed to pay $100/tcm for Turkmen gas at the Turkmen-Uzbek border, up 54% from the current price of $65/tcm. It is understood that most of the gas will be resold by Gazprom's affiliate RosUkrEnergo (RUE) to Ukraine. According to Gazprom, Turkmenistan agreed to fix the price until 2010. The agreement calls for Turkmenistan to supply 12 bcm this year (in addition to 30 bcm previously contracted at $65/tcm) and 50 bcm/year in 2007-2009, for a total of 162 bcm. The Turkmen president also said he was ready to sign a long-term contract with Gazprom covering gas supplies for the next 25 years.

Higher Turkmen Price Will Be Passed On To Ukraine
Gazprom will certainly pass on the Turkmen gas price increase to Ukraine. We expect that Ukraine's price increase will be delayed until the end of the year, and the extra costs incurred by Gazprom and RUE in 4Q06 will be factored into the 2007 price.

Ukraine's Gas Import Price Will Reach $130-140/tcm in 2007
We expect Ukraine's gas import price to increase in 2007 to $130-140/bcm at the Ukraine-Russia border, up from the current price of $95/tcm. The increase will translate into higher prices for industrial consumers, to about $155-165/bcm including transportation and supply cost.

Chemicals Sector Faces Hardship, Others Less Affected
The higher gas price in 2007 will put fertilizer producers in trouble and push them to modernize, while metals plants and thermal power generators (GenCos) will be less affected. The government has said it will provide support to industry if the 2007 gas price exceeds $135/bcm, and it is not unlikely that the support could be biased towards businesses close to the Party of Regions. The government says it has put $600 mln into a "stabilization fund", which would be used to compensate for the short-term impacts of any price increase to greater than $135/tcm. This theoretically could be done through tax and duties privileges, cheap loans or loan guarantees, and/or gas price discounts.

Gazprom Gives In? We doubt it ...

We didn't expect Gazprom to give in so easily to the Turkmen president's demand for a gas price increase – we expected Gazprom to bargain the Turkmenbashi down to $80/tcm at most. Given that Gazprom's ultimate target is control over Ukraine's gas transportation system (GTS), Gazprom is strongly motivated to retain as much price leverage over Ukraine as possible. By giving a price increase to Turkmenistan, Gazprom reduced its own leverage.

However, in return for giving the Turkmenbashi the full price increase he was demanding, Gazprom received larger contracted volumes (indeed, 50 bcm/year might be more than Turkmenistan is capable of exporting to Russia, as the Turkmen-Uzbek-Kazakh-Russia pipeline route has limited capacity). Gazprom also fixed the price for the next three years.

Moreover, Gazprom's relatively prompt acceptance of the price increase makes us suspect that it was a compromise in which the most interesting details were not made public. For example, Gazprom could have agreed to pay a premium for Turkmen gas in return for some non-price benefits (notably, when Gazprom accepted a $90/tcm price increase for Kazakh gas in May, Gazprom in return received access to several oil and gas fields). In other words, we suspect that the true economic value embedded in the Turkmen deal is not visible. Nonetheless, the officially announced price increase will be used to push up the price for Ukraine.

The May Kazakh gas price increase, from $50/tcm to $140/tcm, could be another argument for Gazprom supporting a price hike for Ukraine. Uzbekistan is surely next in line – we suppose it will ask for about $120-125/tcm, based on the deals Gazprom arranged with Kazakhstan and Turkmenistan. RUE plans to buy 15 bcm/year of Kazakh and Uzbek gas in 2006-2010. The company supplied 4.4bcm of Kazakh and Uzbek gas to Ukraine in 1H06.

Gas Import Price to Reach Triple Digits

The Turkmen price increase will certainly be passed on to Ukraine. The price for Ukraine in 4Q06 implied by the Turkmen price increase is about $120-130/tcm, bringing the average price for 2006 to $102.5/tcm ($8.1 below our forecast made in June). However, we admit that there is a high possibility that Gazprom could tolerate a delay in increasing Ukraine's import price until January, to let the Ukrainian government meet its 2006 budget plan and simplify the negotiation process.

The new price level needs to be negotiated by the end of September, when Turkmenistan is due to finish delivering to Russia the 30bcm contracted at the old price. We expect the government will manage to negotiate a new gas import price of $130-140/tcm and a delay in the price increase until January 2007 by offering some assets and/or favors to Gazprom.

Gas imports from Gazprom's affiliate RosUkrEnergo are *de jure* a mixture of Central Asian gas and Russian gas (~80%/20% in 7m06), with Russian gas supplied to RUE at a price that began at $230/tcm in January 2006 with quarterly adjustments based on the oil price (which has increased). Theoretically the $95/tcm price that Ukraine currently pays to RUE was arrived at through balancing lower Central Asian gas prices with the higher Russian price.

What Can Ukraine Offer to Gazprom to Get A Discount?

We expect the Ukrainian government to make a serious effort to bargain a lower gas price than the one implied by the Turkmen price increase. The offers to Russia could include assets, licenses or other favors. Yury Boyko, the energy minister, who is due in Moscow this week (Thursday) for negotiations with Gazprom, said his negotiations would touch on "ten factors" that affect Ukraine's gas import price, of which he described only two: RosUkrEnergo's exports to the European Union and the transport tariff that Ukraine charges to Gazprom and RosUkrEnergo.

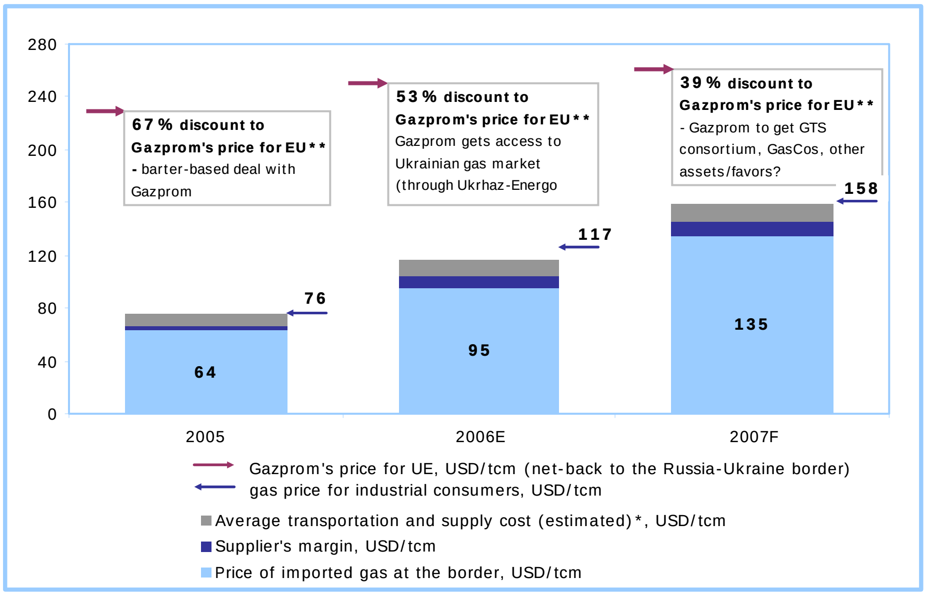
We believe that Ukraine has little power over those two factors. The gas transportation tariff is set for five years in the January 2006 Ukraine-Russia gas agreement, and RUE's exports are under Gazprom's control. We do not know what the other eight factors are, but we believe most are somehow related to Ukrainian assets.

Gas Transportation Consortium. Recently the Cabinet revived the idea of an international gas transportation consortium. Although it is unclear whether the government is suggesting that the consortium formed in 2004, 50/50% between Russia and Ukraine, be revived, or if a new consortium would be created, the major issue is which pipelines it would control. The Ukrainian government says the consortium would manage only currently idle pipelines and those that the consortium would build, while Gazprom obviously seeks to gain control over the whole system, especially the trunk lines.

Gas Distribution Companies. Another favor Ukraine is obviously ready to give is access to its local gas distribution network. The state is considering selling Ukrainian gas distributing companies (GasCos, see our report of Aug. 22) to Ukrhaz-Energo (UGE), the JV created by Naftogaz and RosUkrEnergo to sell gas within Ukraine. There have recently been reports that Gazprom's partner in RosUkrEnergo, Moscow-based Ukrainian businessman Dmytro Firtash, is accumulating stakes in GasCos by buying shares off the market. Another Russian business group close to the Kremlin owns controlling stakes in several Ukrainian GasCos, which might be offered to Gazprom. The Ukrainian government, through Naftogaz, still has majority stakes in many GasCos, which we believe it is considering selling to UGE, RUE or Gazprom.

Other Gas and Oil Companies. Gazprom might be interested in other assets wholly or partially owned by the Ukrainian state, such as municipal heating enterprises, the national gas and oil transportation companies Ukrtransgas and Ukrtransnafta, or domestic oil company Ukrnafta, in which the state owns a majority stake. According to a recent report in the newspaper Kommersant, citing an unnamed source at the Raiffeisen banking group (the banker for RosUkrEnergo), Gazprom recently requested a valuation of Ukrnafta and six GasCos.

Ukraine's Yearly Average Gas Prices*, 2005-2007F



** ex. VAT; 2007 – base case forecast (4Q06 gas import price remains $95/tcm, $135/tcm starting Jan 2007); supplier's margin means required profitability for Ukrhaz-Energo (UGE)/Naftogaz, which is added to the import price to determine gas price cap for the industry*
*** Gazexport price was taken as a benchmark (estimated, net-back to Russia-Ukraine border)*

Source: National Energy Regulation Commission (NERC), Ukrainian News agency, Concorde Capital estimates

$130-140 at the Border in 2007

Our calculations of RUE's increased costs since January 2006, including the Turkmen gas price increase effective in 4Q06, the May increase in the Kazakh gas price and our expectation that the Uzbek gas price will be increased soon, imply that Ukraine's gas import price should increase to $140-145/tcm at the Ukraine border in 2007, implying a price for Ukrainian industrial consumers of $165-170/tcm (excluding VAT, but including transportation and supply costs).

However, we expect the government will bargain a delay in the price increase till January 2007 and a $5-10 discount in the price in 2007 by offering assets and/or other favors to Gazprom. Thus, in our base case forecast we assume a price of $130-140/tcm at the border starting January 2007, and no increase this year. That would mean about $155-165/tcm ex-VAT price for industry next year.

Last month, Nikolai Azarov, the first deputy prime minister and finance minister, said the price of imported gas assumed in his (as yet unpublished) draft 2007 state budget was $135/tcm, but he stressed that it was only a provisional number.

No Direct Contracts for Turkmen Gas

We do not expect Ukraine to succeed in contracting Turkmen gas supplies directly with Turkmenistan, as the volumes contracted by Russia do not leave any room for additional sales to Ukraine. This is in line with our earlier forecast.

Chemicals At Risk, Others Less So

The price of gas for industrial consumers would make producers of nitrogen fertilizers barely profitable, forcing them to focus on large-scale modernization, and making all of them – including the covered Cherkasy Azot, Dniproazot and even Stirol – more open to possible takeover bids. The steel industry would bear the higher gas costs more easily. Lower margins in the short-term would rebound in the mid-term as mills reduce gas consumption. Thermal power generating companies (GenCos) would suffer a temporary decrease of their profitability, but in the mid-term would pass the higher gas cost on via electricity tariff increases.

Government Support

Azarov said recently that the 2007 budget would set aside $600 mln in a "stabilization fund", which the government would use to soften the impact to industry of any gas price hike exceeding $135/tcm. Intuitively, the forces that supported Viktor Yanukovich during the 2004 presidential elections and the Party of Regions during the 2006 parliamentary elections have more chances to get that money. The most likely forms of the government's support would be cheap loans, cancellation of VAT on imports of fixed assets needed for plants' modernization, and gas price discounts.

RUE to Remain Profitable

We estimate RUE will remain profitable in 2006 despite the higher Turkmen gas price in 4Q06, even if Ukraine's gas price increase is delayed till January 2007. However, if Ukraine's price increase is delayed, we expect about $420 mln of extra costs incurred by RUE/Gazprom in 4Q06 would be factored into Ukraine's 2007 import price, or compensated by non-price favors to Gazprom/RUE/UGE. In addition to its income from supplies of gas to Ukraine and the EU, RUE earns income from its 50% stake in Ukrgaz-Energo, which supplies gas on the Ukrainian domestic market.

RosUkrEnergo Economics in 2006, Updated

SALES TO UKRAINE

Case 1: Ukraine's price increase is delayed until January 2007 (base case)

	Volume bcm	Cost USD/ths cm	Price USD/ths cm	Gain/Loss USD/ths cm
Russian gas	10.1	230.0	95.0	-135.0
Turkmen gas	37.6	73.8	95.0	21.3
Uzbek gas	3.8	44.0	95.0	51.0
Kazah gas	5.0	95.0	95.0	0.0
Total	56.5	101.6	95.0	-6.6
		Cost USD mln	**Revenue USD mln**	**Gain/Loss USD mln**
		5738.2	5367.5	-370.7

Case 2: Ukraine's price increases in 4Q06

	Volume bcm	Cost USD/ths cm	Price USD/ths cm	Gain/Loss USD/ths cm
Russian gas	10.1	230.0	102.5	-127.5
Turkmen gas	37.6	73.8	102.5	28.8
Uzbek gas	3.8	44.0	102.5	58.5
Kazah gas	5.0	95.0	102.5	7.5
Total	56.5	101.6	102.5	0.9
		Cost USD mln	**Revenue USD mln**	**Gain/Loss USD mln**
		5738.2	5791.3	53.1

SALES TO EUROPE

	Volume bcm	Cost USD/ths cm	Price USD/ths cm	Gain/Loss USD/ths cm
Turkmen gas	4.4	73.8	250.0	176.3
Uzbek gas	3.2	44.0	250.0	206.0
Kazah gas	3.0	95.0	250.0	155.0
Russian gas	6.9	230.0	250.0	20.0
Total	17.5	133.6	250.0	116.4
		Cost USD mln	**Revenue USD mln**	**Gain/Loss USD mln**
		2337.3	4375.0	2037.7

Net gain/loss (ex. transportation cost) – Case 1	**2090.8**
Net gain/loss (ex. transportation cost) – Case 2	**1667.0**
Approx. transit cost, USD mln	1084.5
Net gain/loss – Case 1	**582.5**
Net gain/loss – Case 2	**1006.3**
For reference: 50% of Ukrgaz-Energo's income*	172.8

** assumed to be consolidated in RUE according to equity method*
Source: Energobusiness (Fuel and Energy Ministry data), Concorde Capital estimates

Appendix. Ukraine's Gas Balance 1H06

	1H05	%	2005	%	1H06	%	2006F	%
SOURCES:								
Own extraction	**10.1**	**24%**	**20.5**	**26%**	**10.3**	**26%**	**20.8**	**27%**
- Ukrgazdobycha (subs. of Naftogaz Ukrainy)	7.3	72%	14.7	72%	7.3	71%	14.7	71%
- Ukrnafta	1.6	15%	3.3	16%	1.7	16%	3.4	16%
- Others	1.2	12%	2.5	12%	1.3	13%	2.6	13%
Imports	**32.6**	**76%**	**57.4**	**74%**	**29.6**	**74%**	**56.5**	**73%**
- from Russia	11.0	34%	20.4	36%	5.3	18%	10.1	18%
- from Middle Asia	21.6	66%	37.0	64%	24.3	82%	46.4	82%
- Turkmen	n/a	n/a	n/a	n/a	19.9	82%	37.6	n/m
- Uzbek	n/a	n/a	n/a	n/a	1.9	8%	3.8	n/m
- Kazakh	n/a	n/a	n/a	n/a	2.5	10%	5.0	n/m
Other (PSA's, etc.)	**n/a**	**n/a**	**n/a**	**n/a**	**0.1**	**0%**	**0.1**	**0%**
TOTAL SOURCES	**42.7**	**100%**	**77.9**	**100%**	**39.9**	**100%**	**77.3**	**100%**
USES:								
Domestic consumption	**37.0**	**85%**	**68.9**	**87%**	**37.2**	**89%**	**70.4**	**91%**
- industry	17.8	48%	34.8	51%	16.6	45%	33.6	48%
- energy	6.0	34%	11.4	33%	4.9	30%	10.9	32%
- genco's*	3.8	64%	n/a	n/a	2.6	52%	5.7	n/a
- metallurgy	**5.1**	**29%**	**9.6**	**28%**	**4.6**	**28%**	**9.1**	**27%**
- chemical	**n/a**	**n/a**	**8.8**	**25%**	**n/a**	**n/a**	**8.4**	**n/a**
- other	6.7	38%	5.0	14%	7.1	43%	5.2	15%
- population and budget enterprises	10.9	29%	20.4	30%	12.4	33%	23.2	33%
- municipal heating enterprises	8.1	22%	13.7	20%	8.3	22%	13.7	19%
Technological use	**4.6**	**10%**	**7.4**	**9%**	**4.4**	**11%**	**7.2**	**9%**
Exports	**2.1**	**5%**	**2.7**	**3%**	**0.0**	**0%**	**0.0**	**0%**
TOTAL USES	**43.6**	**100%**	**79.0**	**100%**	**41.6**	**100%**	**77.6**	**100%**
Sources - uses	**-0.9**		**-1.1**		**-1.7**		**-0.3**	
GTS and transit gas, net balance	0.9		1.1		1.7		0.3	
BALANCE	**0.0**		**0.0**		**0.0**		**0.0**	

For reference:

	1H05	%	2005	%	1H06	%	2006F	%
GTS gas:								
- taken from storages and pipeline system	9.5		17.6		8.9		17.7	
- pumped into storages and pipeline system	7.4		15.3		6.2		17.4	
GTS gas balance	**2.1**		**2.3**		**2.7**		**0.3**	
Transit:								
- Incoming	65.9		132.5		64.8		138.1	
- from Russia	n/a	n/a	126.1	95%	n/a	n/a	n/a	n/a
- from Asia	n/a	n/a	6.2	5%	n/a	n/a	n/a	n/a
- Gazprom	n/a	n/a	n/a	n/a	62.3	96%	125.0	91%
- RosUkrEnergo	n/a	n/a	n/a	n/a	2.5	4%	17.5	9%
- other	n/a	n/a	0.2	0%	n/a	n/a	n/a	n/a
- Outgoing	67.2		133.7		65.8		138.1	
- Gazprom	63.7	95%	110.0	82%	62.3	95%	125.0	91%
- RosUkrEnergo	2.2	3%	n/a	n/a	3.5	5%	17.5	9%
- EuralTransGas	1.2	2%	n/a	n/a	0.0	0%	0.0	0%
- Other	0.0	0%	26.4	20%	0.0	0%	0.0	0%
Transit balance	**-1.2**		**-1.2**		**-1.0**		**0.0**	

** Source: Energobusiness (Fuel and Energy Ministry data), Concorde Capital estimates*

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