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The Ukrainian-Russian Gas Consortium
(Kishinev, October 2002)
- A Comment -

Summary:

We comment on the Ukrainian-Russian Gas Transit Consortium signed in October 2002. In general, we support its intention to secure reliability of supply of Russian gas to European markets through Ukraine. However, since even both partners of the consortium together do not have the funds available to finance badly needed investment measures in the pipeline system, we also stress the need to include a third-party investor. Since profitability of gas transit through Ukraine depends on future developments on European gas markets, the extent to which bypass routes for Russian gas can be explored and used in the future and supply changes of other gas-exporting countries, we opt for a flexible scheme in which specific investment amounts are determined in response to changing profitability.

Outline:

1. Introduction

2. Assessment of the Agreement

3. Outlook: How to Include a Third Party Investor?

4. Conclusions and Necessary Future Research

1. Introduction

On October 7, 2002, the Cabinet of Ministers of Ukraine and the Government of the Russian Federation signed a bilateral agreement. In general, we consider this agreement to be a step in the right direction. The main objectives of such strategic cooperation as stated in Articles 2 (cooperation between Russia and Ukraine) and 3 (activities of the consortium) are to establish Ukrainian gas-transit systems as a reliable, safe and stable delivery option for Russian gas to European markets, and to attract further investments for the necessary modernization and improvement of the pipeline system. These intentions coincide with our previous recommendations on that issue.[1]

2. Assessment of the Agreement

Nevertheless, while we do expect the agreement to promote Ukraine's reliability as transit partner between Russia and Western Europe, we criticize that the official agreement[2] does not properly address the issue of attracting future investments. This however is crucial since technical installations are fairly old (only 15% of all pipes are less than 15 years old, around 32% are more than 26 years old, 17% even older than 35 years, while average user time for pipes is approximately 33 years) and various studies report a dramatic need for upgrading of the compressor stations and anti-corrosion protection of the pipes. Hence, attracting investment will be key for sustaining long-run functionality of the pipeline system, reducing transit costs and thus, maintaining profitability. According to various estimates, necessary investment will cost about USD 500 m to USD 2 bn—most realistically around USD 600 m—for a period of about 5 years. The wide range of estimates reflects different information on technical conditions of the pipeline systems what further increases uncertainty for potential investors.

According to own statements by the two organizations, which (according to Article 4) establish the consortium, "Gazprom" and "Naftogas Ukraine", the magnitude of necessary investment projects exceeds their financial possibilities.[3] If that is the case, then an **external** investor (or a group of investors) needs to be included in the consortium. Accordingly, Article 3 lists "...attraction

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[1] Deutsche Beratergruppe Wirtschaft: Vollgas! Zur wirtschaftlichen Zukunft der ukrainischen Gastransitpipeline. Beraterpapier N 28, March 2000.

[2] http://www.rada.kiev.ua/laws/pravo/new/cgi-bin/show.cgi?nreg=643_790

[3] As it was for example mentioned by several speakers during the International Conference OIL & GAS 2002, Ukraine Transit Capacities: Strategy of Development, Kyiv, October 29, 2002. This statement however is somewhat surprising, given the fact that annual after-tax profits of the transit pipeline business for the Ukrainian side alone amount to several hundred million USD (which would largely suffice to finance the investment).

of necessary investment resources for modernization and development of the gas transportation system of Ukraine" as one of the consortium's activities. So far, no further details are specified.

3. Outlook: How to Include a Third Party Investor?

Why is it so important to specify how to include a third party investor? In general, there are two different options of how to include a third party into the consortium:

Option A: Requesting a fixed amount of investments (e.g. USD 600 m) from a third party in order to enter the consortium (alternatively, selecting the bidder who offers the highest investment level).

Option B: Integrating the third party into the consortium without a fixed investment obligation; consequently, splitting up the profits of the consortium according to the share of investment of each participating party.

The problem of Option A is the uncertainty about the current state of the pipeline system. Given the large variance of different estimations it appears to be very difficult to determine the economically most efficient investment level. Also, it is not efficient that the investment decisions be taken by someone who does not carry financial responsibility for its financing. In addition, so-called "external shocks" caused by e.g. unexpected changes in oil prices or further liberalization of the European gas market,[4] quantity and/or price reactions of other gas exporters to the European Union (mainly Norway and Algeria),[5] or the use of bypass pipelines for Russian gas,[6] will definitely have an impact on profitability and thus, optimality of investment levels within the duration of the consortium (30 years). For all theses reasons, we do not recommend to pre-determine investment levels and search for potential entrants into the consortium based on such sums.

Instead, we opt for Option B where the operation of the pipeline system is given to a special purpose vehicle comprising Naftogaz of

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[4] Here, the main issue is whether or not gas prices are decoupled from oil prices and in how far consumer prices can continue to decline in response to further liberalization.

[5] Currently, total annual gas imports into the European Union amount to about 250 bcm (billion cubic meters) out of which about 90 bcm originate from Russia).

[6] Possible bypass routes around Ukraine are through Belarus, the Baltic sea or the route from Poland into Slovakia. Such options are seriously considered by GAZPROM officials, as e.g. the presentation of Y. Komarov, Deputy Chairman of the Board of OJSC GAZPROM at the Conference OIL & GAS 2002, Ukraine Transit Capacities: Strategy of Development (Kyiv, October 29,2002) has demonstrated just recently.

Ukraine, Gazprom, and a third (or more) investors. The advantage of this option is that while the consortium still guarantees the reliability of gas supply, investment into the pipeline system is planed and conducted in an economically efficient way. To achieve that, the concession contract should be set up through pre-determined duration, risk allocation and concession fee. This leaves investment planning to the concessionaire who has the highest incentives to invest efficiently, and thus to maintain and probably even increase his profits by improving the technical state of pipelines, pump stations etc.[7]

However, as recent experiences with concession contracts in for example Kazakhstan have demonstrated, the key to success of such arrangements is a high level of transparency throughout both, the negotiation as well as the operation phase. In particular, public availability of final contracts, publicly available information about tender procedures, an open discussion on risk allocation as well as regular audits through international and independent accounting firms are key requirements for achieving an efficient outcome. For the case of the transit pipeline, transparency of contracts is particularly important since this system is a state asset of Ukraine, in fact the most valuable asset the country has. Thus, its use should be subject to democratic control, e.g. through the Parliament, eventually also through the "Cour des Comptes" (Bundesrechnungshof).

Finally, "transparency" also requires independent information on the market value of the pipeline system, e.g. expected profits from gas transit to Europe through Ukraine's pipelines minus necessary investments. Without such an input it will be impossible to judge whether specific arrangement within the consortium—e.g. on profits signed away to other investors in return for investment funds—are "fair" or not from e.g. Ukraine's perspective. Besides information on the technical state of the system, which is necessary to estimate the "true" need for investments,[8] profitability depends crucially on the impact of "external shocks" (as mentioned above). However, no

[7] This exactly coincides with concession schemes that we have already proposed in previous work (see footnote 1). In this earlier work, we have estimated the discounted value of future profits from the pipeline transit activity at about USD 1-2 bn. A more detailed analysis will have to be carried out to update this estimate.

[8] These figures vary widely in different studies. While our estimation of approximately USD 600 m. within the next 5 or so years is taken from the World Bank, a recent EU-INOGATE study estimates total funds necessary for the next 20 years to up to USD 15 bn. Finally, other sources quote Russian statements of about USD 2 bn. per year (Kiev Post, October 31st, 2002).

up-to-date results of such a study are available thus far. Therefore, further research is overdue.[9]

4. Conclusions and Necessary Future Research

Given the procedure in which the agreement on the gas consortium has been achieved between the Cabinet of Ministers of Ukraine and the Government of the Russian Federation without that any detailed information has yet been made available to the public, the high degree of in-transparency is our main criticism thus far. In contrast, the next steps—the inclusion of a third party—must be carried out in a more transparent way. This even more, because so called "external shocks"—e.g. further liberalization of the gas market in Europe, bypass-options etc.—will have an impact on profits and efficiency levels of investment. What is needed in this context is an independent study to evaluate profitability of the gas-transit system based on alternative scenarios. Only with the help of such results it will be possible to specify a "fair" position for Ukraine in the up-coming negotiations. Thus, preparing such a study will be an important task for our future work.

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Kyiv, October 2002

[9] Beraterpapier N 28 (see footnote 1) presents results of a previous scenario analysis along these lines. However, the underlying study is based on information from 2001 and therefore, requires updates in data and strategic constellations. Nevertheless, the report gives a useful idea of the further potential of such information. It can be downloaded from the German Institute of Economic Research (DIW) at: www.diw.de/deutsch/publikationen/diskussionspapiere/docs/papers/dp261.pdf.