

Reforming the Natural Gas Market in Ukraine: the Process of Unbundling (Unbundling Case)

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Abstract

By choosing the European vector of development and trying to integrate into the European energy market, Ukraine has committed itself to implementing European directives and regulations (EU Third Energy Package) and is interested in creating effective institutional support in the gas market. Unbundling is a prominent issue in this package, and it leaves the Member States the choice of two options: “ownership unbundling” versus an “independent system operator”. According to the EU’s Third Energy Package, Ukraine needs to carry out the process of separating its gas transmission system from production and supply of natural gas or electricity – so-called “unbundling”. In general, the Third Energy Package is a package of laws aimed at increasing the efficiency of the energy market and creating a single market for gas and electricity in the EU. The purpose of this scientific and practical investigation is the issue of restructuring of “Naftogaz of Ukraine”, the legal regime of use of property of distribution networks, further reform of the gas industry in Ukraine. The chronological order of the unbundling process in Ukraine was observed by analysing legal backgrounds & gaps in it. It was defined that the blocking process lasted until September 2019. With the arrival of the new government, an essentially new process of unbundling began, the terms of which were dictated by Naftogaz whose Executive Board is trying to retain control over the revenues from gas transit. Gaps & problems of GTS Operators (the new one as well as old one) were discovered. It was found that the new GTS Operator (Gas Transmission System Operator of Ukraine LLC), which was created by Naftogaz, continues Naftogaz’s policy of including all problematic volumes of gas (no payment for which was received by Naftogaz) on the balance sheet of the GTS Operator.

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1. Introduction

The implementation of European directives and regulations into national legislation and the creation of appropriate institutional support is a complicated and ambiguous process that is supposed to take into consideration the internal national characteristics of the gas industry and the economy as a whole. This process of implementation involves a number of constraints that should be taken into account in order to achieve the changes not of a framework, declarative nature but the positive goals which triggered their implementation.

Since 2011, Ukraine has been a member of the Energy Community, an international organization that includes both EU member states and countries outside the EU. Membership in this organization is an important step towards the integration of the national energy sector into EU energy markets, as the goal of the Energy Community is to disseminate and approve European

energy standards in order to create a single market [1].

By choosing the European vector of development and trying to integrate into the European energy market, Ukraine has committed itself to implementing European directives and regulations and is interested in creating effective institutional support in the gas market.

To this end, the EU has so far developed the EU’s Third Energy Package - a package of laws on the internal European gas and electricity market [2].

The third energy package came into force in September 2009. Its main elements are the demonopolization and liberalization of energy markets in the interests of the consumer, the reforming of the corporate governance of state-owned energy market operators, the unbundling of property, the creation of full-fledged national markets for gas and electricity. Unbundling is a prominent issue in this package, and it leaves the Member States the choice of two options:

“ownership unbundling” versus an “independent system operator” [3].

The EU energy policy, presented in EU-Ukraine Association Agreement (hereinafter – the AA) [4], has two legal regimes that complement each other: the AA, on the one hand, and the Energy Community Treaty, on the other [5].

As follows from the provisions of the Association Agreement, both regimes are synchronized. While the AA sets the general framework, the Treaty establishing the Energy Community is a *lex specialis*. In other words, detailed energy commitments are set out in the latter. EU-Ukraine AA plays only a supporting role and is a framework. In addition, in the event of a conflict between the provisions of the EU-Ukraine Association Agreement and the provisions of the Energy Community Treaty or the relevant EU law applicable under such a treaty, the latter shall prevail (Article 278 (1) AA).

One of the first examples of decision-making by the Association Council, which affects the development of relations between Ukraine and the EU, is the Decision of the Association Council № 1/2019 of 8 July 2019 on amendments to the appendix XXVII to the EU-Ukraine Association Agreement [6]. This decision envisages updating the obligations on the scope of approximation of Ukrainian legislation to EU law in accordance with the goal of integrating energy markets of Ukraine and the EU and conducting a joint audit of compliance with draft acts adopted in the areas covered by the obligations under appendix XXVII.

The decision of the Association Council № 1/2019 was approved by the Law of Ukraine № 2739-VIII of 6 June 2019 [7].

In accordance with this decision, changes and additions to the appendix XXVII to the AA are made in order to provide more detailed rules for monitoring the approximation of Ukrainian legislation to EU law in the energy sector (the deadline for implementation is from the end of 2019 to the end of 2021).

Despite numerous political declarations in the past, real work on the implementation of the provisions of the Third Energy Package in Ukraine began only after 2014. Nevertheless, to date, our country has fulfilled almost all its conditions, in particular, has introduced a new wholesale electricity market, which will operate in accordance with the principles of the EU Third Energy Package [8].

The ultimate goal of the implementation of the EU Third Energy Package is to increase national energy security, service quality and institutional integration of Ukrainian energy markets into a single European gas transportation system ENTSO-G and energy system ENTSO-E.

2. Materials and Methods

The authors used several research methods, which were determined by the goal and tasks of the article. In order to attain the objectivity of their conclusions the authors used some general scientific methods, such as analysis and synthesis, and special legal methods, such as comparative legal method and method of legal interpretation. In order to substantiate their theoretical conclusions, the authors were guided by the provisions

of general theory of law and theory and practice of international law.

The EU Third Energy Package provides a revised regulatory framework for promoting the integration of, and increased competition in, EU gas and electricity markets. The package is comprised of two separate Directives for gas and electricity (Directive on rules for the internal market in electricity, 2009/72/EC and Directive on common rules for the internal market in natural gas, 2009/73/EC), which are required to be implemented by the Member States, and more detailed rules contained in three related regulations (Regulation 713/2009 establishes the Agency for Cooperation of Energy Regulators; Regulation 714/2009 establishes conditions for access to the network for cross-border exchanges in electricity, and Regulation 715/2009 establishes conditions for access to the natural gas transmission networks).

According to the EU's Third Energy Package, Ukraine needs to carry out the process of separating its gas transmission system from production and supply of natural gas or electricity – so-called “unbundling”.

In general, the Third Energy Package is a package of laws aimed at increasing the efficiency of the energy market and creating a single market for gas and electricity in the EU. Implementing the provisions of the Third Energy Package is a difficult and long way.

Research of separate aspects of the functioning of the world and national natural gas markets in particular the corresponding institutional maintenance, systems of tariff formation, problems of realization of the international obligations concerning the reforming of organizational and legal model of the gas market is presented in scientific works of local and foreign scientists such as R. Podolets, O. Dyachuk, G. Burlaka, I. Kopytin, I. Shikhizade, V. Saprykin, I. Pashkovskaya, O. Seleznyova, J. Cher, M. Slaba, N. Haase, L. Mazeisen, A. Kovacevich, D. Geradin, Growitsch, C., Stronzik, M. and others [9] - [13].

At the same time, the aspect of institutional reform of natural gas liberalization is practically absent in these works. And in Ukraine, the analysis of changes in the institutional structure of the natural gas market under the updated European legislation is virtually absent.

Thus, the purpose of this scientific and practical investigation is the issue of restructuring “Naftogaz of Ukraine”, the legal regime of the use of property of distribution networks, the further reform of the gas industry in Ukraine.

3. Results and Discussion

In 2015, in order to replace the Law of Ukraine “On the Principles of Functioning of the Natural Gas Market”, a new Law of Ukraine on the Natural Gas Market was adopted, which entered into force on 1 October 2015 [14]. Analysing this Law, we will not aim at its comparative analysis with European standards, but we can identify both positive and problematic trends in the natural gas market for industrial and domestic consumers. Regulation of the gas market in Ukraine is far from ideal, even “the process of semi-liberalization is underway” [15].

In essence, the monopolization of the natural gas market causes the absence of a competitive model in which the price of gas for industrial consumers is determined solely on a market basis (based on supply and demand). The process of reforming the natural gas market lies in the solution of the institutional structure.

Under the Third Energy Package unbundling means the separation of energy supply and generation from the operation of transmission networks. If a single company operates a transmission network and generates or sells energy at the same time, it may have an incentive to obstruct competitors' access to infrastructure. This prevents fair competition in the market and can lead to higher prices for consumers. Unbundling is also the basis for the establishment of a highly competitive market and, more importantly, the strengthening of rules on consumer protection – meaning that a person who directly or indirectly manages a production or supply undertaking cannot have control over the operator of the transportation system.

Ukraine committed to fully transpose and implement the Third Energy Package under the Protocol of Accession to the Energy Community Treaty, signed back in 2010 and ratified by the Verkhovna Rada. This commitment naturally includes mandatory compliance with the unbundling requirements in both the natural gas and electricity sectors.

In the case of Naftogaz, unbundling meant the separation of its gas transportation activities (the activities of the Gas Transmission System Operator (hereinafter – GTS) from its extraction and supply. Thus, implementing the European approach, Ukraine has committed itself to separating the GTS operator into an independent structure. The new GTS operator was to gain independence not only from the then-current owner, Naftogaz, but also from any other influence from natural gas producers and suppliers, in particular through the vertical of public authorities. In Ukraine, the unbundling process was more like a thriller, and its results as of early 2020 are little different from the conditions of 2014. The unbundling process was started even before the adoption of the Law of Ukraine on the Natural Gas Market [14].

The unbundling date should be considered 4 June 2014, when the Cabinet of Ministers of Ukraine adopted Resolution №172 [16], by which it agreed with the proposal of the Ministry of Energy and Coal Industry to establish a public joint-stock company “Trunk Gas Pipelines of Ukraine”, 100 % of the shares of which are in the state ownership of Ukraine in order to increase the energy security of the state and bring the functioning of Ukraine's gas transmission system in line with Directive 2009/73 / EU (third energy package).

Back in 2014, this resolution instructed the Ministry of Energy and Coal Industry, the State Property Fund together with the National Joint Stock Company Naftogaz of Ukraine, and the public joint-stock company Ukrtransgaz to ensure that the property which is used for the transportation of natural gas and is not subject to privatization and accounted for on the balance sheet of the public joint-stock company “Ukrtransgaz” will be transferred to PJSC Trunk Gas Pipelines of Ukraine in the manner prescribed by law.

The requirements of Resolution 172 have not been met, as well as all subsequent regulations on unbundling, which were adopted before September 2019.

During this period, “Naftogaz Ukrainy” has gone from being the main initiator of transparent unbundling in 2014 to completely denying its initiatives in 2019. At the same time, a radical change in views on the unbundling process at “Naftogaz Ukrainy” coincided with the process of forming unauthorized selections (imbalances) of natural gas in the gas transmission system, which did not exist until 2014. And the greater such imbalances, the more radically Naftogaz denied its previous initiatives, on the basis of which the unbundling process was built.

The peak of gas imbalances in the gas transmission system was reached in the summer of 2019, when their value was estimated at about UAH 40 billion. It was during this period that “Naftogaz Ukrainy” sent a letter to the Cabinet of Ministers of Ukraine denying its own proposals, on which the entire regulatory framework for unbundling was built.

The chronological order of the unbundling process is as follows.

Following the adoption of the afore mentioned Resolution №172 of 16 June 2014, the Cabinet of Ministers of Ukraine on 25 March 2015 adopted the Order №375-r on Gas Sector Reform Issues, which approved the Gas Reform Action Plan agreed with the World Bank and the Energy Community Secretariat [17].

In pursuance of paragraph 18 of the Plan of Measures to reform the gas sector, NJSC “Naftogaz” of Ukraine sent its proposals (its Restructuring Plan of NJSC “Naftogaz” of Ukraine) on 31 March 2016 on the procedure for full separation of the GTS operator from the “Naftogaz” group.

Complaining in 2016 that the reform was 5 months behind, Naftogaz itself, in its Restructuring Plan, proposed the process of unbundling the GTS operator in a “way and with such a sequence of steps to ensure the protection of Ukraine's economic interests, in particular not to jeopardize Naftogaz's position in arbitration proceedings against Gazprom and not to cause default on Naftogaz's financial obligations, including those guaranteed by the state”.

The proposals of NJSC “Naftogaz” of Ukraine in the proposed Restructuring Plan were as follows:

Full separation of the GTS operator. The proposal presented in the Plan stipulates that in relation to the operator of the state-owned gas transmission system, a model of full separation of ownership of the GTS (OU model) should be chosen in accordance with the Law of Ukraine on the Natural Gas Market.

The operator of the gas transmission system is the joint-stock company ‘Trunk Gas Pipelines of Ukraine’ (MGU) – a business company, 100% of the shares of which belong to the state.

Based on the above key proposals of Naftogaz on the Restructuring Plan, the Cabinet of Ministers of Ukraine adopted the basic Resolution №496 of 1 July 2016 on the separation of activities for transportation and storage (injection, selection) of natural gas.

This government resolution as well as Naftogaz's proposals provided with the aim to:

- choose the model of separation of natural gas transportation activities provided for in Article 23 of the Law of Ukraine on the Natural Gas Market, as a model of separation for the state-owned gas transmission system operator of Ukraine that is not subject to privatization (OU model);
- establish the PJSC "Trunk Gas Pipelines of Ukraine", 100% of the shares of which are state-owned. The deadline being 1 October 2016;
- approve the list of assets, material, technical and other resources necessary for the effective operation of PJSC "Main Gas Pipelines of Ukraine" and the plan for their transfer to the aforementioned company;
- ensure that PJSC "Trunk Gas Pipelines of Ukraine" submits a request to the National Energy & Utilities Regulatory Commission of Ukraine for certification of the gas transmission system operator.

On 9 November 2016, the Cabinet of Ministers of Ukraine, in accordance with the requirements of Resolution № 496, adopted the Resolution № 801 on the establishment of the Public Joint-Stock Company "Trunk Gas Pipelines of Ukraine (Mahistralni Gazoprovody Uktainy/MGU) (TGPU)" [18], 100 % of the shares of which belong to the state.

Subsequently, the Cabinet of Ministers of Ukraine adopted a number of normative documents which defined the tasks and indicators for the Supervisory Board and the head of NJSC "Naftogaz" of Ukraine and which provided for unbundling on the basis of the above conditions which were never fulfilled.

After the establishment of JSC "Trunk Gas Pipelines of Ukraine" (TGPU), the company "Naftogaz" of Ukraine began to block the unbundling process, which was initiated by it. None of the conditions proposed by the Company itself and Resolution №496 on "Trunk Gas Pipelines of Ukraine" to become a GTS Operator were met.

In September 2018, after a protracted period of miscommunication and failed attempts of cooperation between Naftogaz and TGPU (MGU), the supervisory boards of both companies signed a general Memorandum of Understanding on unbundling, which was intended to define a common goal in the process of separation of the GTS under the ownership unbundling model. This model requires full independence of the future transmission system operator from any other interests in the gas market.

At the beginning of 2019, Naftogaz established the Limited Liability Company Gas Transmission System Operator of Ukraine (LLC GTSOU) and began to demand that the GTS operator be not the Trunk Gas Pipelines JSC TGPU (MGU), but its subsidiary, Gas Transmission System Operator of Ukraine LLC.

The blocking process lasted until September 2019. With the arrival of the new government, an essentially new process of unbundling began, the terms of which were dictated by Naftogaz whose Executive Board was trying to retain control over the revenues from gas

transit. In particular, to replace the Resolution of the Cabinet of Ministers of Ukraine № 496, the new Government adopted the Resolution № 840 of 18 September 2019 on the separation of natural gas transportation activities and ensuring the activities of the gas transmission system operator [19].

This Resolution stipulated that the GTS operator must pay Naftogaz part of the transit revenues for the next 10 years, using the so-called "dynamic price".

According to the executive director of Naftogaz, Yu. Vitrenko, this amount for the entire period should be UAH 180 billion (\$ 7.5 billion). This requirement is absurd in its content, assuming that the cost of a new transit contract is the same amount.

On the basis of Resolution 840, the Verkhovna Rada of Ukraine adopted a law on the separation of the GTS [20].

The presentation of the working conditions of the GTS in accordance with this bill was presented by the Chairman of the Board of Naftogaz, Andriy Kobolev, at a meeting of the Verkhovna Rada Committee on Energy and Housing and Communal Services in October 2019 [21]

According to the presentation and the requirements of the new law on the separation of the GTS, it was envisaged that JSC Trunk Gas Pipelines of Ukraine, as a joint stock company, 100 % of whose shares belong to the state and corporate rights management by the Ministry of Finance, will own and manage the GTS Operator. At the same time, the certification as a GTS operator and the license for gas transportation will not be passed by JSC Trunk Gas Pipelines of Ukraine, but by a subsidiary of Naftogaz (Gas Transmission System Operator of Ukraine LLC).

It should be reminded that both the new GTS Operator and the old Ukrtransgaz have a significant problem with balancing gas in the GTS, which is the result of the formation of bad debts of Ukrtransgaz at about 45 billion UAH and, accordingly, the formation of losses. Such losses are a consequence of inefficient management of Naftogaz by the GTS Operator (Ukrtransgaz).

The new GTS Operator (Gas Transmission System Operator of Ukraine LLC), which was created by Naftogaz, continues Naftogaz's policy of including all problematic volumes of gas no payment for which was received for Naftogaz on the balance sheet of the GTS Operator.

Naftogaz and the new GTS Operator are aware that the new company that owns and operates the GTS Operator cannot continue the agreement policy towards Naftogaz in matters of natural gas imbalance.

In addition, after signing the new terms of the transit contract, according to which Naftogaz retained itself in the chain of transit revenues, the issue of control over the GTS Operator becomes necessary for Naftogaz – to be able to keep the largest amounts of transit revenues on its own accounts using the old mechanisms of interaction between the GTS Operator and Naftogaz in gas imbalance issues.

After signing the new terms of the transit contract, it is not profitable for Naftogaz to hand over the control of the GTS Operator to an independent state-owned

enterprise (in this case, JSC “Trunk Gas Pipelines of Ukraine”). Therefore, Naftogaz has launched a campaign to discredit JSC “Main Gas Pipelines of Ukraine”, which has not even started its activities to manage the GTS Operator.

In fact, Naftogaz is launching a targeted attack in advance – so that JSC “Main Gas Pipelines of Ukraine (TGPU)” has neither the funding, nor the management capacity to influence the new GTS Operator.

The main task of JSC “Trunk Gas Pipelines of Ukraine (TGPU)”, in contrast to Naftogaz, is to try to maximize the profits of the GTS Operator. Naftogaz has a completely opposite task – to minimize the profit of the GTS Operator through long-established schemes (through gas imbalances in the gas transmission system).

Naftogaz is interested in liquidating JSC “Trunk Gas Pipelines of Ukraine” and its “historical” memory, along with documents indicating that it was Naftogaz that blocked the unbundling process and changed its position in the process, trying to disrupt the contract for gas transit through Ukraine.

At this stage, Gas Transmission System Operator of Ukraine LLC is a “weak” link in the formation of an independent Operator. All its actions indicate dependence on Naftogaz and attempts to “avoid” independent management by JSC “Trunk Gas Pipelines of Ukraine (TGPU)”.

In its turn, Naftogaz explained that the delay in the unbundling process is due to the fact that any loss by the company or Ukrtransgaz of control over the assets used for gas transit without the consent of Gazprom can create significant financial risks. Thus, the supervisory boards of the Naftogaz and TGPU agreed that the litigation with a Russian monopolist in the Arbitration Institute of the Stockholm Chamber of Commerce made it impossible to carry out the process of unbundling by 1 January 2020.

As the new GTS Operator, Gas Transmission System Operator of Ukraine LLC, did not sign a long-term transit contract with Gazprom, its existence as LLC owned by JSC “Trunk Gas Pipelines of Ukraine (TGPU)” has lost its meaning.

The GTS operator should be JSC Main Gas Pipelines of Ukraine, as a joint-stock company, 100% of the shares of which belong to the state and are completely independent of Naftogaz. At this stage, an effective solution would be to reorganize Gas Transmission System Operator of Ukraine LLC by fully joining the joint-stock company “Trunk Gas Pipelines”.

4. Conclusions

By choosing the European vector of development and trying to integrate into the European energy market, Ukraine has committed itself to implementing European directives and regulations and is interested in creating effective institutional support in the gas market.

According to the EU’s Third Energy Package, Ukraine needs to carry out the process of separating its gas transmission system from production and supply of natural gas or electricity – so-called “unbundling”.

Summarizing the above, we can say that the real unbundling did not take place. The contract for gas

transit through the territory was concluded not with the GTS operator, but again with Naftogaz Ukraine. The operator is deprived of the opportunity to defend its interests directly to the customer of gas transit services and is forced to act through NJSC “Naftogaz of Ukraine”.

The level of dependence of the GTS operator on Naftogaz is measured by the need to pay in favour of Naftogaz in the next 15 years \$ 7.2 billion, which is an unbearable burden for the GTS of Ukraine. Naftogaz Ukraine continues the practice of “dumping” all bad debts for gas to the GTS operator, taking away a significant share of revenues from gas transit.

As a result, the failure of Ukraine to implement the unbundling plan would have an impact on the country’s European integration course.

The struggle for key assets in the gas sector may threaten Ukraine’s future accession to the EU. Uncertainty about the reform of the gas sector will affect end consumers – namely ordinary Ukrainians – as well as the geostrategic value of Ukraine in the eyes of European partners.

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