

Walter Boltz: I think there is rather unlikely that it would be zero transit through Ukraine after 2020

- **In October the supervisory board of MGU made a statement that there is a lack of cooperation between you and supervisory board of Naftogaz, that unbundling process has been stopped and the Memorandum of understanding you've signed is not discharged. Naftogaz SB answered that they were surprised by such announcement. So what is going on between supervisory boards of MGU and Naftogaz? What are the reasons of your announcement?**
- First of all, the reason it was said two month ago was that cooperation between SB boards was really difficult at the beginning. That is not so unusual. I've been through the unbundling procedures in Western Europe. And normally the integrated companies like Naftogaz find it very complicated to accept that unbundling has to happen. Because it means loosing influence, loosing some strategic advantage and that's why there is always quite a bit of resistance against unbundling procedure. And in EU we had a long discussion about unbundling models also.

If to speak about Naftogaz, they are also not so enthusiastic about unbundling. But don't forget the decision of the Ministry of energy form 2015, and the necessity of the implementation of the Third Energy Package and the cooperation with the EU Energy Community. So basically it has been clear for the couple of years that unbundling process has to happen. Such reluctance is not really specific for Naftogaz. It is a normal reaction of integrated companies. At the same time, of course, Ukraine has some specialties. I mean, there was long lasting arbitration procedure between Naftogaz and Gazprom. Transit of gas is probably a more important part of the economy of Ukraine than in many other countries. For example, Belgium or Austria also has a large share of transit, but not as big as in Ukraine. Also in Ukraine there is the political dimension of the armed conflict in the Eastern Ukraine and the occupation of the Crimea and extremely bad relationship between Russia and Ukraine. So this is all overlays the whole process.

So when the MGU SB started in March 2017 there was extremely little communication with Naftogaz. We had only few meetings and were looking forward how to move in our cooperation. Then finally this year we've signed the Memorandum of understanding, actually, it was not an agreement between the companies, just between supervisory boards. And then we had a couple of points that took us nearly two months to negotiate them, because some people during the process had changed their minds and had a version that was not finally acceptable to the supervisory boards and so on. At long last, we came to a version of the Memorandum that both sides had signed in August 2018. And then it was difficulty in implementing the general agreement, because a couple of issues were left that needed to be addressed. And it took relatively long to get on with the signing of a non-disclosure agreement (NDA). The other issue was that Naftogaz should provide some financing for the MGU SB, because basically MGU is without any financial means at the moment...

- **Let me ask you to specify this moment. So after signing Memorandum there was still no progress in your negotiations with Naftogaz SB or you've started the dialog?**
- Well, the dialog started, but it took rather long before we've started practical implementation steps. And there are several reasons: as I've mentioned, we had a very long discussion about signing NDA and how the process of receiving confidential information would be handled.
- **And SB of MGU has already signed the NDAs?**

- Actually, after some discussions we came to the conclusion that the only thing that can be established is an agreement between Naftogaz and MGU and not between individuals of the supervisory board. So now we have a NDA that is in place with MGU and, of course, as supervisory board members we have confidentiality agreements with MGU. First the idea of Naftogaz was that each individual member of the MGU SB signed a NDA with Naftogaz, which was really not acceptable for us. Because an individual person versus a huge company, and also being under Ukrainian legislation with an undefined liability is not something that is really acceptable for a person. So it took several months until it was cleared that this NDAs were not individual, but were signed between the companies, and only then we've started to get some information from Naftogaz. That was one of the backgrounds of our announcement that was made in the end of October.
- **So now you have effective communication with Naftogaz SB?**
- It has started very slowly. In the meantime we did receive some information and we are having some discussions with Naftogaz. At least some progress was made.
- **Let's talk about the problems with the salary payments for MGU SB. For now Ukrainian government has no funding for MGU and that's why Naftogaz proposed you all to sign an employment agreements. So the company is ready to hire MGU SB as the advisers in unbundling process. And as far as I know, MGU SB is concerned about its independence. Could you clarify the situation? Did you sign the employment contracts?**
- I want to emphasize that we didn't sign any contracts and we accepted that we won't get any money from Naftogaz for our advisory role. So we still are doing sort of an advisory role in the unbundling committee of Naftogaz supervisory board. And we will attend the next meeting at the middle of December. So on the factual level we are cooperating and we are providing our expertise to the unbundling process. But after some discussions we decided not to sign the employment contract and not to receive any money from Naftogaz.

The history is that when the government provided the budget for MGU, it provided finance for 2018 and this did not include sufficient funding for the SB. So we were a little bit surprised that when we've started our work, that there was a budget for the small staff of MGU, it's like 10-12 people, working in the company with relatively modest salaries. But there is no money for the SB. But after writing to the government, it became clear that in current framework of the political changes and elections it was unlikely that the government would provide additional funding for 2018. The Ministry of energy was not ready to provide any additional funding. So when negotiated the Memorandum of understanding with Naftogaz, it was general agreement that NAK would provide some money for MGU to pay the SB.

And then when we had discussed specific details, the only option Naftogaz proposed was a salary to employers. And after some discussions we decided that employment is not an acceptable option. Because an employee has a certain loyalty towards employer which is natural. But we are in the status of the SB and our primary loyalty should be towards MGU and to Naftogaz. So that's a fundamental conflict that would have been resolvable, for example, if Naftogaz would have given some money for MGU. Because it's a payment between two state-owned companies, that's perfectly all right. But in an employment role we felt this this would create the appearance of a serious conflict of interest.

- **But in such case, receiving money from Naftogaz wouldn't compromise your independence as the directors of the SB?**
- It's basically theoretical. It's never materialized. The only option we've discussed with Naftogaz – was an employment option. And we came to the conclusion that this is not acceptable. Therefore during the second half of 2018 the MGU SB is not receiving money from the state; our travel expenses are also not covered. We do hope that for 2019 there will be a reasonable budget for MGU including for the SB.
- **Have you discussed funding of MGU for 2019 with the government already?**
- Yes, there is a line item for MGU budget for 2019. And when the budget would be approved by parliament we should have the funding for the next year. And MGU would be able to pay for its normal activities and for the SB. For 2018 we decided to look for another options but not to take money from Naftogaz.
- **I was told by the Chairman of the Naftogaz SB Clare Spottiswood that both supervisory boards are discussing a signing of the draft contracts between MGU, Naftogaz and the government. What these contracts are about?**
- There is an unbundling plan that Naftogaz presented in September. It probably has the concept that Naftogaz will prepare the subsidiary company within Naftogaz structure with all the functions. And this company would then be transfer to MGU. It should happen that way, if it is decided to follow the Naftogaz plan. And you've seen the letter that development partners – World Bank, US Embassy EBRD and Energy Community Secretariat – wrote to the Ukrainian premier-minister, saying they feel that it's really not much progress in the unbundling process and that they are afraid that the whole process will stop, because 2019 – is the election year etc. So the development partners are waiting for the binding agreement that would be signed as soon as possible. That would already commit both sides to take over the TSO activities no later than the end of the year 2019. So basically the development partners said that they want to create a situation, in which the unbundling can't be stopped. According to the Naftogaz plan, they have to move all activities needed for operating an unbundled TSO to the subsidiary company they established. Any time they could decide not turn over the shares to MGU. Also the certification of the TSO cannot be done if MGU is not the owner of the pipeline assets and if it's not independent. So to prevent this happening we need binding contracts.
- **According to my information, MGU and Naftogaz are in discussions about the type of unbundling process. As we all know the unbundling plan implicates the ownership unbundling (OU) model, but now it's going to be changed on ISO-unbundling model. Can you confirm or deny this information?**
- I don't have this information. Now we work on the assumption that it would be ownership unbundling as the Government has clearly stated. Obviously, ISO could happen within the current legal framework, but it's very complicated and not an optimal structure. You have to understand the history of the unbundling. When in 2007-2008 the Third Energy Package was designed, there was initially only ownership unbundling. And then a few countries came forward, for example Ireland, and said they have a very special structure and the OU will be very complicated to fulfill. To make them happy, European Union allowed the ISO-model for very special cases. Basically it means that you hold on to all the assets and activities, but you turn over every decision to somebody else who is not becoming the owner of the assets, but becomes the ultimate decision-maker (like a

trustee) on everything. For good reasons we have very few ISOs in Europe. And it's not a very good structure, because it is difficult to manage the complex systems, if the institutions, which make all the decisions, is not the same one that has all the financial consequences of these decisions. So in Ukraine we are talking about the ownership unbundling.

- **If to get back to the letter of the development partners you've mentioned, they wrote that they were concerned about the unbundling process. Except political and pre-elections reasons do you personally see any other risks for unbundling?**

- This is a difficult question. From the objective point of view, I believe, unbundling is very important for Ukraine. Since Europe has a big interest in retaining a sizeable amount of transit through Ukraine, so it's also in the interest of EU that there is a credible unbundling. Don't forget, why do we do unbundling in EU? Because only with neutral and independent companies you can develop market. So the real check for unbundling is – would the market participants believe that the company which is operating the transmission system is truly independent of any other interests. In Ukraine do you believe that any TSO, when all the assets are held by Naftogaz, would give the Russians and Europeans a comfortable feeling that this is truly independent? I don't think so. And any unbundling becomes useless, if the resulting structure is not seeing as independent by the users of the transportation system. And obviously, the most critical users of the Ukrainian transmission system are the Russian company Gazprom and the western buyers of the Russian gas. If they don't believe there is an independent TSO, there is no sense in unbundling. That's why it's so important for Ukraine to do proper unbundling. And on the other side, we are looking at an activity that is very profitable and economically important – the gas transit. So it's not surprising that Naftogaz is not so enthusiastic about giving such business to someone else.

- **The pipeline business is profitable when there is a transit. But we all don't know what would be with the gas transit through Ukraine after 2020. So that's why it's highly important to attract western gas companies as the partners to operate Ukrainian gas system. As we all know, there several companies that have such interest and have already formed a kind of Consortium. Can you tell about your work with the potential partners?**

- To continue the gas transit through Ukraine beyond the 2021-2022 is in interest of Europe and Ukraine at least for another ten years. On the other hand, the Russians are not so enthusiastic about it. They would much rather avoid Ukraine. We will see how it comes out, but I don't want to predict anything. I can only say that EU and Ukraine have shared interest on having a long-term sizeable transit agreement. And in this context some of the Western gas transmission system operators (TSOs) (some on their own initiative and some had been pushed by their governments) have established the Consortium several months ago. They are signing an appropriate agreement, which doesn't mean that much, but they are discussing transit with Naftogaz, MGU and we are discussing jointly.

- **How many western TSOs are in that Consortium now?**
- Nearly five to seven TSOs. Some of them have already joined the Consortium, some are still discussing that issue.

- **So what is the purpose of Consortium? Are Consortium members going to operate the Ukrainian unbundled business?**

- Well, they want to become involved into the operation of the Ukrainian gas transmission system. The exact form of involvement is still under discussion. What is also clear, that they have no interest in buying 49% of pipeline assets. Nobody from them would spend billions on buying a share in the Ukrainian transmission system at that stage. I think they have real interest in being involved in the operation of it. They are ready to participate in management, they are ready to help in organizing (maybe not directly) sufficient money for improvements and modernization of the system. So they are ready to substantially contribute, but not paying for existing old assets.

And why is that beneficial for Ukraine? Because such a Consortium would make it more likely that a long-term contract with Gazprom could be signed. Because many of those TSOs are from countries, that are the big buyers of the Russian gas. They have been transporting Russian gas through their pipelines for more than 25 years. And, if they become the part of the management of the Ukrainian gas transmission system, and they would help assure that it's properly managed, that there are cost-oriented tariffs, the necessary investment are made – all these increases trust and then it is more likely that long-term contract can be established.

- **If European TSO would come to operate the Ukrainian transmission system, could it become the real argument for EU that it doesn't need an additional Russian gas pipeline, I mean, the Nord Stream-2?**
- My personal view is that – unfortunately - Nord Stream-2 is at such point that it's very unlikely that it will be stopped. So, it will happen. But, none the less, there is still a room for quite a bit of transportation volume through Ukraine. And, if the problems with signing the long-term contract between Russian and Ukraine are removed because of Western partners would help to operate the system and negotiate with Gasprom, I think it will be easier to get a long-term transit contract.

Also, you shouldn't underestimate that this is not a purely commercial decision. But some of the TSOs that are in the Consortium, they are state-owned, and their governments are in contact with the Russians. So there would be pressure from those countries, which are the big buyers of the Russian gas, and they will try to put pressure on Russia to continue using the Ukrainian gas route. So I think that the framework for the establishing the long-term contract will be improving. There is no guarantee, but it will be better than what we have now. I mean, we all know that relationship between Naftogaz and Gazprom are not the best, so with the help of the Consortium it could be easier to establish the negotiations between these two companies.

- **As far as I know, Naftogaz looks for several scenarios which could be realized after 2020. If the worst scenario for Ukraine comes true and we wouldn't have any transit after 2020, what we have to do with our pipeline than?**
- Obviously, MGU and Naftogaz are working on different scenarios, because now nobody really knows what will happen after 2020. So any prudent management has to look into different options. But I think there is rather unlikely that it would be zero transit. For various reasons it would be very complicated to go into such scenario. I think it's relatively likely that it would be some transit. If to speak about volume it could be something between 15 and 50 bln cubic meters. Of course, that is not as much as now, but it's a little bit more than Moldova and Serbia. I think there should be strong political initiatives to make sure that there is a bigger amount of transit.

Also I'm sure that in the long run Ukraine has a good position, because Ukraine has a sizeable gas reserve. If the production of gas is expanded, the potential that exists in your country is properly

used, than there is a need of quite a substantial transportation system in Ukraine. And also there is some potential of exporting gas for the Western buyers. So even without transit or with the much smaller amount of transit the transportation system has its own role and will continue to have a role. Of course, if it's only half of the amount of transit, the economic has to be changed, the structural adjustments has to be made. And the longer the current volumes of transit can be continued – the better. If to speak about the time frame, unless a miracle happens, I think, Russia will need at least two more years – 2021-2022 – to use a lot of capacity through Ukraine. Many experts are saying it's very unlikely, that Nord Stream-2 would start before 2022.

- **So we have a little bit more time to do an unbundling?**
- You have a little bit more time. Of course, in gas transportation business two years is not that much. Because a normal time frame for contracts are usually 10-15 years. But Europe would rather prefer to have clarity till 2020-2021.

- **If after 2020-2021 Ukraine will have much smaller amount of transit, should we think about finding investment for the reducing of the pipeline capacity?**
- Well, I think for now it's very important to establish the long term contract as soon as possible. I mean longer than until 2021. It wouldn't be good, not only for Ukraine, but also for Europe, if we would have a contract only for two years. And as I said the long-term contract should be about sizeable volume. Of course, Ukraine will never come back to the transit volumes it has 15-20 years ago, but the new contract should be about at least a bigger volume. It will be a need of downsizing some transportation capacity, because I don't think that full capacity will be needed. But, of course, if you have ten years to do it, it will be much easier and not so expensive, than in two years.

And, at the same time, you have to work on increasing the production volume. Ukraine has quite some potential for gas production.. And you have a very well developed transportation system. And even if you look ahead longer, the EU is thinking about decarbonizing the energy sector, including gas. And Ukraine has a lot of biogas potential and also a big wind power potential. So Ukraine has quite a potential role in supporting the long term changes in the European energy system. So it's important to have long-term perspective, to make all the reforms and preparations of the energy sector to be successful in the new environment. There are many steps to get there. One is the unbundling, the other is the increasing production of your own gas, the other one is looking for the potential cooperation between Ukraine and Europe. Because your country is well connected with a neighbouring markets, you can operate a quite successful gas hub. But, of course, no one will trade gas in a market, that doesn't have a very independent TSO.