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and analysis from the Bloc of Yulia Tymoshenko (BYuT)

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Gas Deal Needs Revision

Prime Minister Yulia Tymoshenko is to reopen talks aimed at brokering a direct relationship between Naftohaz Ukrainy, Ukraine's state-run gas company and Gazprom, its Russian counterpart. Last week's accord was applauded for its proposed removal of RosUkrEnergo, the controversial gas trader that supplies a mix of Russian and Central Asian gas to Ukraine. However, the suggestion that a new joint venture between Naftohaz and Gazprom be established was rejected by the government and will be the subject of further talks.



Delighted by the news to remove RosUkrEnergo, Prime Minister Yulia Tymoshenko last week described it as "a great victory for the democratic team."

Yet today's concern is over the proposed replacement of one joint venture with another. The government is maintaining its desire for a direct contractual relationship between the two state-owned gas companies and the whole issue will be tabled for discussion during Ms Tymoshenko's visit to Moscow this week.

Regardless of what is decided, for the time being, RosUkrEnergo will continue to supply gas until a replacement structure is in place.

A significant aspect of the accord agreed last week concerns the removal of UkrGazEnergo. It was proposed that a 50-50 joint venture between Naftohaz and Gazprom be established to handle domestic sales inside Ukraine. This amounts to a significant coup for Gazprom which would gain partial control of the Ukrainian gas market – something it has long cherished.

"Distribution is the prize," said Elena Herold, an analyst at PFC Energy.

Last Thursday the government decided to liquidate UkrGazEnergo as "the first step to impose order and create another scheme for gas deliveries in the domestic market." However, according to Yuriy Prodan, the Minister of Fuel and Energy, such a liquidation "will take some time." Talks are now underway to define terms and mediate with the company.

Last week, the government also agreed to start paying off the \$1 billion debt demanded by Gazprom. A repayment of \$100 million was made on 14 February. In return the Russians backed off from threats to raise the price of gas beyond the \$179.50 per thousand cubic metres agreed in 2007.

An agreement with Gazprom is tantalisingly close. Much will depend on Ms Tymoshenko's visit to Moscow which hopefully will result in greater clarity and be cause for celebration.

A Tale of Populism and Inflation

It is normal politics in any democracy for an opposition to use every opportunity to criticise the government. The Bloc of Yulia Tymoshenko (BYuT) and government has supported the adoption of a law on the opposition and state positions for the opposition that would permit them to check upon the government's activities. The 2006-2007 Anti-Crisis Coalition, of which the Party of Regions was the largest member, never attempted to pass a law on the opposition.

Criticism should be ideally both warranted and truthful. Criticism should also not be undertaken by an opposition that is imbued with double standards.

The charge of 'populism' routinely thrown against the Tymoshenko government by the Party of Regions is a case in point. The term 'populism' has become a much maligned term that spans a multitude of different ideologies on both the left and right. Any use of the term therefore should be made with circumspect.

The definition used by the Party of Regions to lambast the Tymoshenko government and BYuT points to the Party of Regions as being Ukraine's true 'populist' party. Four examples point in this direction.

Firstly, the Party of Regions most closely resembles a popular front than a political party. As a popular front it incorporates an eclectic mix of billionaire oligarchs, former organised crime bosses, trade unionists, ex-Red directors cum bona fide businessmen, and former Communists.

Secondly, the Viktor Yanukovich government is a proponent of economic protectionism. In 2004 the Yanukovich government opposed the transfer of the Kryvorizhstal steel plant to foreign owners based on the argument that 'strategic' enterprises should belong in Ukrainian hands. The Party of Regions criticised the foreign purchase of Kryvorizhstal in 2005 after it was put up for sale following its re-privatisation by the Tymoshenko government.

Thirdly, both Yanukovich governments in 2002-2004 and in 2006-2007 supported widespread price controls in the energy sector and grain export quotas. The energy price controls damaged foreign investors and forced Cardinal Resources to quit the Ukrainian market.

Fourthly, both Yanukovich governments unleashed the highest inflation rates of the last four years. In 2004 and 2007 the annual inflation rate was 12.3 and 16.6 percent respectively. In comparison, the inflation rates under the two Orange governments in 2005 (Tymoshenko) and 2006 (Yuriy Yekhanurov) were 10.3 and 11.6 percent respectively.

In the post-Orange Revolution era, when Ukraine is emerging as a young democracy, it is incumbent upon Ukrainian politicians to move away from the Kuchma-era when they said one thing, signed another and did a third. As seen from the Yanukovich government's economic and fiscal policies, and its about turn on supporting NATO membership in the Kuchma-era while opposing it today, it is far more difficult for the inheritors of the Kuchma regime's ideology to transform themselves, even with the help of US advisers.



▲ The Yanukovich government unleashed the highest inflation rates of the last four years.



Reviving Naftohaz

The planned elimination of RosUkrEnergy and news that this does not signal a new hike in the price of imported natural gas is music to the ears of those tasked with restructuring Naftohaz, Ukraine's state-run gas company.

A joint team headed by the ministries of Fuel and Energy and Finance is putting the finishing touches to a strategic development plan designed to put Naftohaz back on a firm financial footing.

Yuriy Prodan the Minister of Fuel and Energy and Viktor Pynzenyk, Minister of Finance told investors that they were getting close to adopting a strategic plan for Naftohaz, which is expected to be tabled within a matter of days.

The Yanukovych-administration allowed Naftohaz to rack up huge debt that brought the company close to bankruptcy and technical default of its Eurobond.

The root of Naftohaz's problem remains the differential between the price its pays for imported natural gas and the price it is forced to sell to domestic consumers. This has been compounded by it being stripped of profitable industrial contracts and saddled with transit fees that are well below market rates. Add to this large overhead costs and some dubious business practices, and it is no wonder that the company came close to insolvency.

Fortunately, the Tymoshenko-administration was aware of its plight and was quick to react. Ministers-to-be even met with anxious bond-holders before they came to power.

Breathing Space

Amendments to the 2008 state budget granted Naftohaz some breathing space to tackle its longer-term issues. Other than nearly \$1 billion set-aside for subsidies, the budget included a provision for \$2.4 billion to cover the cost of a sovereign guarantee. The guarantee exists as a framework and in order for it to be utilised, the Cabinet of Ministers needs to take more steps that would enable the Ministry of Finance to apply the budgetary allowance. However such is the political will and focus on getting Naftohaz profitable, that it is highly unlikely that the provisions of the sovereign guarantee would be called upon.

Both the president and prime minister have made the saving of Naftohaz a top priority and President Viktor Yushchenko convened the National Security and Defence Council to discuss the issue, calling for a financial plan to be tabled within 10-days of its meeting.

With the new financial plan in place, the government is expected to revise the state budget to include provisions for subsidies and possible tax regimes for the company.

Mr Pynzenyk talked about the initiative from the two ministries that meet on a daily basis to address the issue, "Our goal is to remove the deficit and in the future we do not plan to support the company from the budget – it should be profitable."



▲ Viktor Pynzenyk, Minister of Finance, is determined that in the future Naftohaz will not be a drain on the state budget. Restoring the company to financial health is a priority.



The new Chairman of Naftohaz, Oleh Dubyna, known as a turn-around expert, was described as “cleaning the stables.” Mr Dubyna is making a strong impression on the company and while the development plan is still work in progress it is understood to include the following:

- To reclaim industrial contracts currently placed with UkrGazEnergo
- Reduce direct subsidies to the company and the tax burden. The Finance Ministry is believed to be prepared to write off the company’s debts to the state authorities depending on the company’s cash flow and the outcome of talks
- Implement a stringent programme of cost control
- Increase domestic extraction

The big question is whether Naftohaz will be allowed to increase gas prices to the domestic market.

“My desire is to touch the budget as little as possible,” said Mr Pynzenyk to investors. While, from an economic point of view there is a willingness to raise gas prices, this may prove an untenable option given political considerations. Should, a decision to raise domestic prices be made now, it would not take effect until the next heating season.

“My desire is to touch the budget as little as possible.”

What the Polls are Saying:

52.7% of the population approve of the actions of Yulia Tymoshenko as Prime Minister.*

27.7% assess her work positively, 23.6% satisfactory and 12.7% as excellent.

32.3% do not trust former-Prime Minister Viktor Yanukovich, compared to 21.6% President Viktor Yushchenko and 19.6% Prime Minister Yulia Tymoshenko.

If a presidential election was called today:

24.8% would vote for Yulia Tymoshenko

20% for Viktor Yanukovich

13.1% for Viktor Yushchenko

3.7% for Petro Symonenko

*FOM-Ukraine. Poll of 2,000 people, 25 January - 2 February, 2008.

Talks over the transit price of gas and the details of the deal announced last week in Russia will also influence the plan.

Political Resolve to Revive Naftohaz

A new wind is blowing through Kyiv. Unlike in the past, the democratic coalition government is determined to bring the company back to profitability and there is a steely focus to do this.

“The company has suffered from a bellyful of quick-fixes, temporary actions and willful neglect,” said Mr Prodan, “of course we are focused on the short and medium-term health of the business, but also on the long-term: securing growth for the future.”

Asked whether the government would look to refinance the company, the response was that “before talk of raising finance we must demonstrate a robust financial plan.”

For the time being, the last word should be with the Bear Stearns analyst Okan Akin who wrote: “We believe that there is a consensus among the political factions in Ukraine that Naftohaz continue to service its foreign obligations and there is now priority focus by the authorities on the company’s position/problems, while the availability of a state guarantee affirms the company’s position as a quasi-sovereign play. As a result of these factors, we maintain our outperform recommendation on the Naftohaz September 2009 bonds.”