UKRAINE

A new oil corridor for Europe

As Russia seizes new export opportunities for oil and Caspian production gains momentum, the Black Sea has become a busy outlet toward the overstretched Bosphorus. Whilst, increasingly, shippers are experiencing exacerbating delays and producers are facing the threat of costly disruption to production, a 14mt/yr pipeline has been sitting idle since it was commissioned in 2002. The pipeline was built by the Ukrainian oil pipeline company, Ukrtransnafta, and links the Black Sea ports of Odessa and Pivdenny with the Druzhba pipeline as it runs through northwest Ukraine. It had been little heard of until recent months, when Ukrtransnafta began to put effort into bringing it into use. The commercialisation attempts have featured prominently on the political agenda domestically and in Ukraine’s dealings with Russia, the EU and USA.

In seeking to diversify crude supply, Brussels actively encourages Ukraine and other transit countries to use the Odessa-Brody pipeline to establish a route out of the Black Sea to the heart of Europe. Following the Prestige and Erica disasters, the EU is particularly interested in a pipeline as an alternative to marine shipping.

Existing unutilised capacity on the Druzhba system should allow for the integration of Odessa-Brody in Slovakia and Czech Republic within a short timescale. Initially, deliveries would flow to the Czech Kralupy refinery, which is already a recipient of Caspian crudes. By avoiding the Bosphorus and at a proposed competitive tariff, Kralupy stands to benefit from improved reliability and lower delivery costs. Further, the new route would allow for the freeing up and reversal of the high capacity, but little used, Ingolstadt-Kralupy pipeline. This in turn would open up a new valve for Russian and Caspian oil to southern Germany, a market with significant appetite for both.

Key Caspian producers and Europe based offtakers are interested in using the transportation corridor. The ability to meet a proven market need at competitive rates should provide the incentive to invest in strengthening the Druzhba system’s batching capabilities and reversal of IKL. The benefits for Russian as well as Caspian producers and for the transit countries on the route should help to overcome historical reluctance to such change, and the accession to the EU of Slovakia, Czech Republic and Poland will help provide the necessary regulatory framework.

Medium to long-term, Odessa-Brody could be extended via Plock in Poland to northern European markets and beyond, via the deep-sea port of Wilhelmsfalen. Fresh investment capital will be required to link the existing pipelines, providing an export outlet for both Russian and Caspian crudes. At the same time, Ukraine retains sufficient pipeline capacity through alternative existing routes to transit additional Russian crude to the Black Sea, if the Russian oil producers see windows of opportunity for exit via the Bosphorus. The opportunity is there for a new oil corridor for Europe.

Stefka Regelous
Corporate Finance, PricewaterhouseCoopers
stefka.regelous@uk.pwc.com

Progress but further reform required

Ukraine’s power sector continued its path towards stable and viable operation in 2003. Payments by distribution and supply companies to the wholesale electricity market (WEM) for purchased power increased considerably and are predicted at 93% in 2003. Further improvement of payments is possible once distributors address non-payment by municipal enterprises and households begin to pay cost-reflective, not administratively fixed, tariffs.

Implementation of the WEM Concept, an energy sector reform strategy approved back in 2002, has progressed slowly. The preconditions for full implementation of the concept are the resolution of sector’s debt problems, full cash settlements between market participants, an improved tariff setting system and liberalised fuel markets. Another key aim is to remove or at least minimise state interference in the operations of sector players and the WEM’s decision-making process. This can only be achieved through complete privatisation of state owned assets in the distribution, supply and generation sub-sectors. One major step towards ensuring a level playing field for generators has been the decision of the WEM to implement so-called “proportional allocation of market funds” whereby all generators are paid for sold power proportionally to the value of their own sales in terms of total sales. This removes all administratively created preferences previously existing in the cash allocation between power producers.

Certain progress has been made in clearing the sector’s debt. The Parliamentary Fuel and Energy Sector Committee approved in November 2003 a draft law “On Repayment of Debts for Energy Resources” that attempts to comprehensively clear debts of $3bn. Further progress in reform and privatisation of the remaining 12 power distributors and four thermal generators depends on the law’s approval by parliament, forecast to take place this spring. If approved, the law will take nine months to be implemented via write-offs, offsets and restructuring. This will most likely mean that privatisation of remaining assets will not happen before 2005, which also makes sense in light of presidential elections due in autumn 2004.

Nevertheless, Ukraine’s power sector, especially its distribution and supply segment, seems to remain attractive enough for private investors. This can partially be confirmed by the decision of AES not to sell their controlling stakes in two distributors, as well as UES’ recently announced plans to purchase various shares in ten others.

However, investment is urgently required in the generation sector, where assets show average depreciation of 75%, both in terms of new plant and rehabilitation of existing capacity, in order to meet forecast demand growth.

Another strategically important decision to be made by Ukraine is how to engage its grid in parallel operation with the UCTE. At the moment, only one part of the Ukrainian system, known as the Burshtyn Island, works in parallel with UCTE. The Ministry of Energy is working on a plan for future connection of the Ukrainian grid to Europe. However, the key aspect in this decision is its form: Ukraine alone or together with Russia.

Yuri Kubrushko, Business development director,
IMEPOWER Investment Group, kubrushko@imepower.com