

Response of Naftogaz of Ukraine to the Consultation on an EU strategy for liquefied natural gas and gas storage.

Naftogaz of Ukraine welcomes the Commission's initiative to develop comprehensive strategies for LNG and UGS facilities. Those are essential components of a) energy security and b) regional markets integration, flexibility and liquidity. Given the intention of the EU to achieve these goals, this Consultation is very opportune and timely.

We agree with the premise expressed in the strategy that granting access to both LNG and storage facilities to countries that currently do not have them or lack spare capacities is of high importance. Predictable and uniform application of the existing legal framework everywhere in the EU will be the key to ensuring that both existing and new infrastructure is utilized fully and efficiently.

Ukraine is an important gas transit route to the cluster of states with a high level of dependency on a single supplier, on which the country itself is very reliant. However, developments in Ukraine also demonstrate how one change in the structure of a system can have a ripple effect across the whole. Introduction of reverse gas flows from EU to Ukraine allowed country's participation in the European gas market. Signing of standard interconnection agreements with TSO's of the neighboring European countries would be another huge step in this direction. Agreements would create legal basis for backhaul operations and offer additional impulse for regional energy security and gas market growth. In addition, access to the largest UGS facilities in Europe would be facilitated.

Major challenge, however, is to finally remove barriers in the way of cooperation with European partners and of connection of the Ukrainian transmission system with the neighboring transmission systems of Poland, Slovakia, Hungary, Romania and others. In particular, to this point Gazprom's (Rus) actions do not allow our system operators to sign and fully implement standard European interconnection agreements. We continue to work with the European Commission to find an amicable solution. With this being said, we also rely upon the Energy Community to further support us in this process.

Ukraine proved to be open and active partner in the EU legislation harmonization. In April 2015 Law on the Natural Gas Market was passed and will be in force starting October 1. Energy Community Secretariat confirmed full compliance of the Law with the EU Third Energy Package requirements. Ukrainian secondary legislation is on its way to support the Law and finally open natural gas market.

Finally, a construction of an LNG terminal in Ukraine would allow supplies from the Caspian basin as another new route of natural gas for the whole region, and, more importantly, a different supply source.

Question 1: Do you agree with the assessment for the above regions in terms of infrastructure development challenges and needs to allow potential access for all Member States, in particular the most vulnerable ones, to LNG supplies either directly or through neighboring countries? Do you have any analysis or view on what an optimal level/share of LNG in a region or Member State would be from a diversification / security of supply perspective? Please answer by Member state / region.

Access of the European countries to LNG are determined by a) physical infrastructure and geographical location as means of supplying it across the EU and b) interconnectedness in part of the legal framework and advanced instruments enabling virtual trading operations.

Even though infrastructure bottlenecks limit access to LNG supplies in certain regions, in certain cases, lack of political will and/or legal framework is the major impediment. For instance, Bulgaria has the technical capability to obtain access to various sources through connection to Turkey and Greece (incl. LNG supplies received by these countries), but the interconnection initiatives have been delayed for several years now. The Czech Republic, Hungary, Slovenia and Romania currently do not utilize the existing technical capacity and their geographical location to tap into the liquid European markets, satisfying their import requirements through long-term contracts.

Similar impediments also hold for Ukraine. Signing Interconnection Agreements and, most importantly, their enforcement would allow various progressive trading mechanisms (incl. through swapping) to ensure market demand for LNG.

Therefore, the priority should be given to ensuring that countries in the region can contract and deliver gas volumes from LNG terminal without technical and legal impediments.

Question 2: Do you have any analysis (cost/benefit) that helps identify the most cost-efficient options for demand reduction or infrastructure development and use, either through better interconnections to existing LNG terminals and/or new LNG infrastructure for the most vulnerable Member States? What, in your view, are reasons, circumstances to (dis)favour new LNG investments in new locations as opposed to pipeline investments to connect existing LNG terminals to those new markets?

In Ukraine, much more so than in the rest of Europe, energy efficiency remains the most effective demand reduction mechanism.

Securing affordable financing issues, uncertainty related to the sources of gas for the project as well as to the passage through Bosphorus have so far stalled construction of an LNG terminal in the country. Ukraine can be an important transit state for Caspian gas to the EU – it is actually the shortest delivery route for the Caspian resources to the European market and it has large spare transit capacity. When the Caspian gas is delivered to the north-west shore of the Black Sea, many countries of the Eastern Southern and Central Eastern Europe will obtain access to a new source of gas – automatically, with no to minimal investment requirements.

Thus, developing LNG supply route within the Black Sea may have important economic benefits, and the availability of free passage through Bosphorus will determine the strength that this link provides to the global LNG market. Establishing transit route through Bosphorus would connect this whole region to the global LNG market.

Factors which may to a certain extent negatively affect potential LNG projects include speculations regarding, in particular, new regional projects which, although presented as a way to diminish risk of supply interruption, may conceal the real threat to a competitive market. In effect, current routes, incl. those through Ukraine, are safe and provide enough capacity to satisfy the EU demand. Secondly, some of the discussed projects may appear too ambitious to be completed. Finally, and most importantly, the diversification presented in favor of these projects does not hold up – these new routes may in fact increase the dependency on a single supplier.

These public speculations have two primary consequences: creating a perception of significant gas volumes coming to Europe, thus diminishing interest in building new LNG facilities and furthering European dependence on a single supplier. Eventually, if the projects come through, Europe will increase its dependence on a single supplier and if they don't, then due to these speculations time for LNG projects implementation will be wasted.

Question 3: Do you think, in addition to the already existing TEN-E Regulation, any further EU action is needed in this regard? Do you think the use of LNG gas and existing LNG infrastructure could be improved e.g. by better storage possibilities, better network cooperation of TSOs or other measures? Please give examples

Circumstances to favour new LNG investments in new locations would include an open, liquid and highly integrated gas market with fully harmonized and equally applicable EU energy acquis.

Due to the high importance of LNG projects for European efforts of diversification, within the European energy regulatory framework there should exist systemic pan-European and national support for LNG projects to facilitate their construction.

Better storage possibilities and access to sites with spare capacities in order to store strategic volumes would provide another level of utilization efficiency.

Question 4: What in your view explains the low use rates in some regions? Given uncertainties over future gas demand, how would you assess the risk of stranded assets and lock-in effects (and the risk of diverting investments from low carbon technologies such as renewables and delaying a true change in energy systems) and weigh those against risks to gas security and resilience? What options exist in your view to reduce and/or address the risk of stranded assets?

With the cost of LNG imports (which reflects both the upfront price for LNG terminal construction where one does not exist in a region and the higher global and European price for the LNG resource itself) currently being higher than that of pipeline imports in Europe, LNG capacity utilization remains low. Gas delivered via pipelines from Norway, the Russian Federation and Algiers is currently more competitive than LNG supplies received in Europe.

However, in the future, LNG projects seem to have a competitive edge being flexible and agile as compared to costly and time consuming pipeline investments.

Question 6: What in your view are the most critical regulatory barriers by Member State to the optimal use of and access to LNG, and what policy options do you see to overcome those barriers? Have you encountered or are you aware of any problems in accessing existing LNG terminal infrastructure, either because of regulatory provisions or as a result of company behaviour? Please describe in detail.

Uneven and disparate application of the Third Energy Package.

Question 9: How do you see worldwide LNG markets evolving over the next decade and what effects do you expect this to have on EU gas markets? Do you expect a shift away from oil-indexed LNG contracts, and if so under what conditions?

Several scenarios could be developed and a large portion of the uncertainty would still remain.

Despite all the conservatism, it may be expected that the global LNG industry will continue to grow. In this scenario the share of LNG supplies in the European energy mix is expected to increase. Directional flows will also change: the share of imports from Qatar and North Africa is going to rise, while deliveries to Asia will decrease. New suppliers from Australia and the USA, who will be primarily orienting themselves towards European and Asian markets, will force altering of delivery routes.

In the mid-term 2 or 3 regasification terminal projects can be expected in Southern and Eastern Europe.

The Russian Federation may constrain the development of the LNG sector in Europe. Gazprom is well in position to engage in price competition with other global producers (current and future LNG providers to Europe). Russian Federation may also strengthen its position on the European LNG market (with new facilities to be established on the North-West of the country) which would still mean increased dependency on a single supplier. Current sanctions may delay these plans, but under present conditions they will not be able to thwart Russian expansion on the European energy market.

Initiation and successful completion of the LNG projects within the Black Sea region will provide an alternative source of gas to the Southern European countries, diminish dependency on a single supplier and strengthen the energy security in the region.

Question 13: What opportunities or challenges do the supply projections for different sources, in particular LNG and pipeline gas and low carbon indigenous sources, present for the use of gas storage / for gas storage operators?

It is important to consider the implication of decreased transit volumes for storages. In those developed as balancing tools for transit gas, more capacity becomes available for storage as transit volumes decrease. In Ukraine – out of the 29 bcm of UGS capacity on the western border, up to 10-15 bcm currently can be made available for independent traders.

Supply projections will primarily affect short-term fluctuation in demand for UGS services.

Question 14: Are, in your view, current market and regulatory conditions adequate to ensure that storages can fully play their role in addressing supply disruptions or other unforeseen events (e.g. extreme cold spells)?

Storage capacities of many European countries are insufficient to fully address supply disruptions or other unforeseen events. At the same time Ukraine possesses the largest storage capacity in Europe of 31 bcm (1/3 of EU28) and is ready to offer capacities on the border with the EU.

However, barriers for the European traders to access the largest storage sites in Europe, e.g. in Ukraine, due to absence of interconnection agreements and/or their full implementation, absence of the harmonized legal framework, incl. tariff regulations, demonstrate the importance of continuous joint actions and enforcing the existing legal framework.

Question 15: As an alternative to mandatory reserves, how could market based instruments ensure adequate minimum reserves?

We believe that since the cost of storage of mandatory reserves can be included in the tariff itself and thus be accounted for, it should remain an important mechanism of ensuring security of supply for European customers.

Question 16: Do you have any analysis or view on what an optimal level/share of storage in a Member State or region would be? What kind of initiatives, if any, do you consider necessary in terms of infrastructure development in relation to storage?

Currently, there is enough UGS capacity to cover a quarter of European annual demand, probably sufficient to provide the necessary security and flexibility without imposing extra burden. The trouble is the uneven geographical distribution of the facilities. In order to avoid the unnecessary infrastructure build-up, conditions need to be created where traders are able and willing to store gas outside of their country's borders – equal application of the Third Energy Package would be the first step. Developing the existing transmission system to create enough bi-directional capacity should remain a priority as well.

Question 19: What do you think are the most critical regulatory barriers to the optimal use of storage in a regional setting?

Uneven and disparate application of the Third Energy Package.

Question 20: Do you think ongoing initiatives and existing legislation can tackle the remaining outstanding issues or is there more the EU could do? Do initiatives need to include additional issues further to the ones described here?

The UGS in the majority of the Central Eastern European countries at the beginning of the heating season are 95-99% full. Ukraine and Hungary, on the other hand, with the largest UGS capacities in the region, have significant spare capacity of 33% and 48%, 2 bcm and 10-15 bcm respectively that could be used by the market to provide liquidity and by the state to guarantee security. We thus welcome Commission's interest in ensuring that UGS capacities are used beyond national borders and increasing a regulatory and market environment that facilitates this change – this will be particularly important in Central Eastern Europe – the region highly dependent on a single supplier.