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Capital Flight: Ukraine's Gas Price Controls Push US Firm Out

By Tammy Lynch

In the midst of Ukraine's ongoing political negotiations to create a new government, a number of worrying signs for the country's potential investors have gone almost unnoticed internationally. During the last two weeks, an independent US energy firm chose to leave the country, while a military-style raid on a major oil refinery called into question the country's ability to enforce the rule of law.

Cardinal resources

On 30 October, Cardinal Resources plc announced plans to sell its Ukrainian assets. The US-owned corporation was one of the first independent oil and gas exploration firms to invest heavily in Ukraine 10 years ago, drawing largely from US investors. Its experience speaks volumes about the difficulties of working in an environment that provides no legitimate avenues for influence on government decisions and no clear rule of law.

According to Cardinal CEO Robert Bensch, his company's exit from the country is necessary because government price controls and increased fees make it impossible to earn a profit – or even to break even. The company, he said, “can't generate any revenue because of capped prices.” (1)

Bensch said the sale of the company's interests was the only viable option available, with bankruptcy protection being the company's sole alternative. (2) The Kuwait Energy Corporation (KEC), which bought Cardinal's assets for \$71

million, will take over the company's share in the operation of four gas fields and three licenses in Ukraine.

According to those close to the operation, Cardinal had intended to invest roughly \$100 million in further exploration, in an attempt to increase Ukraine's domestic gas production. The country now depends on Russia's Gazprom for 85% of its gas. KEC likely will move forward with these plans, after a pause to allow more favorable conditions to develop. Investors are waiting, said Bensch, and are hopeful for more favorable conditions under the new government, which should be confirmed by mid-November. Regulations have "stopped most foreign investment" in the energy field, leaving the country "18 months behind" where it would have been, he said. (4)

Decree 31

Cardinal's difficulties began in December 2006, when Ukraine's government included a new regulation for international and domestic businesses in its 2007 state budget. The regulation specifies that all companies in joint-ventures with state-owned enterprises must sell their products to one state-designated company at a fixed price. (5)

In February 2007, Ukraine's government enacted the widely condemned "Decree 31." This measure forces energy companies like Cardinal to sell its product to the state-owned Naftohaz Ukrainy, at a price set by Naftohaz Ukrainy. The price offered was approximately \$1.50 mcf (1 mcf=1,000 cubic feet). This price is almost 300 times lower than the market price of around \$4 mcf for which Cardinal sold its product in 2006, before the new regulations. It is also below Cardinal's production costs of \$1.70 mcf. (6)

At the same time, the cabinet raised taxes and royalties on profits for most companies operating in Ukraine to 30%-50% of gross profits. It, therefore,

became impossible for Cardinal and other similar companies to break even, let alone to make a profit.

In response, Cardinal repeatedly met with Ukraine's officials, including Fuel and Energy Minister Yuriy Boiko, to urge them to rescind Decree 31 and return to market pricing. Cardinal representatives also say they sought assistance from US government officials, but to no avail.

Another oil and gas exploration firm, Europa Oil and Gas plc, went to court following the passage of Decree 31. The company won its case based on Ukrainian legislation governing foreign investment that guarantees the right to sell at market prices. The court ruled that the company could sell its gas at market prices, but it has been reported that the government is simply ignoring the ruling. (7)

In response, several production companies attempted to stop selling their gas domestically, pumping it into storage instead. Cardinal received information, however, that its gas has been taken from storage by Naftohaz Ukrainy. The company has been unable to confirm this report. (8)

Bensh and others interviewed for this article suggest several reasons for the government's actions:

First, Decree 31 was passed during the pre-election season. By capping gas prices, Yanukovich could guarantee low domestic prices for a limited time. The increased taxes also could be used to help maintain budget expenses, which ballooned prior to the election.

Second, some suggest that companies like Cardinal and Europa have been caught in a larger struggle between Ukrainian business interests for control of both Ukrnafta, Cardinal's state-owned joint venture partner, and the country's

overall gas network. The gas network is Ukraine's most lucrative asset, generating up to a quarter of the country's GDP.

Ukrnafta

In 2006, Ukrnafta produced 70% of Ukraine's total oil and gas condensate and 16% of its natural gas output, according to a May 2007 report from Dragon Capital. (9)

Although the state owns a 50% + 1 share in Ukrnafta, it has been de facto controlled by Pryvatbank (a subsidiary of the Pryvat Group), which technically owns only 42%. The CEO of Pryvatbank/Group, Ihor Kolomoisky, controls the Ukrnafta board and most of its assets. This is thanks to former President Leonid Kuchma, who reportedly allowed Pryvat "free rein in directing Ukrnafta," and who allowed Kolomoisky to install personnel loyal to him. (10)

Those close to the situation suggest that Yanukovich's government may have attempted to dilute Kolomoisky's control over Ukrnafta through various techniques, in order finally to assert the state's majority interest. Those techniques appear to include minimizing Ukrnafta's profits through Decree 31.

According to Ukrainian investment firm Concorde Capital, Ukrnafta has suffered significantly from the price caps imposed by Decree 31 and by an increase in their tax and royalty payments to 50%. Like Cardinal, Europa and others, Ukrnafta has been unable to profit from sales of its product. The company reported a 48% year on year drop in 9M EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). (11)

Kolomoisky vs. Firtash

This drop in revenue has allowed fellow oligarch Dmitro Firtash to gain a foothold in Kolomoisky's interests. Firtash controls the gas distribution company

Ukrgezenergo—a subsidiary of gas intermediary RosUkrEnergo—and Ukrnafta’s direct competitor. His interests are primarily co-owned with Russia’s Gazprom.

Firtash has pushed in the last year to dominate Ukraine’s entire gas system, from extraction to production to distribution. The government’s new regulations have (possibly unintentionally) assisted him, as his international gas sales have cushioned his companies from the cap on domestic prices. (12)

All of this reportedly has forced Kolomoisky into a deal. Firtash now is said to have taken over the controlling share of Ukrnafta. This information could not be confirmed. If it is true, one company, backed by Russia, may now control Ukraine’s entire gas system, with only the pipelines remaining clearly under state control. The most important effect of Decree 31 may be a lessening of the already limited competition that existed in the gas sector.

The political response

This is an issue that likely will be one of the first on the agenda of the new Ukrainian government of Yulia Tymoshenko. At an investor event in September, Tymoshenko suggested that the state must create more effective competition in the energy field. She also stated that she would initiate a complete overhaul of business regulations, with many simply being removed. In particular, when asked about “Decree 31,” she said, “Without question, that has to go. It can’t remain. It’s not a complicated issue.” Further, “We need market mechanisms.” (13)

Tymoshenko and her allies also have expressed concern at the increasing number of “corporate raids” on large companies, and the effect of these raids on the energy market. The raids have affected at least two of the country’s oil refineries, as businesses fight for control of production capacity.

The raid on Kremenchug

Just two weeks ago, a group of “private security guards in camouflage uniforms”

arrived at the Kremenchug Oil Refinery, located in Ukraine's Poltava Oblast, and physically took control of the plant. The CEO who has run the plant since 2004 was removed, while the former CEO (from 2004) was reinstated. The Ukratnafta corporation, which is largely owned by Russia's Republic of Tatarstan and which controls the plant, immediately stopped supplying the refinery with oil. (14)

Since the refinery provides up to 50% of all domestic oil products, the price for petrol and other oil products in Ukraine has begun to increase.

Pavlo Ovcharenko, the CEO reinstated by armed guards, claims he was reinstated to the position thanks to a court order. That court—located in another oblast—reportedly ruled that 18% of the shares in Ukratnafta, which are controlled by companies friendly to Tatarstan's interests, should be transferred to the state, giving it control.

Corporate raiding and corruption

In its report "Corruption, Democracy and Investment in Ukraine," The Atlantic Council of the United States identified "raiding" as one of the key areas of corruption in the country. (15) Various sources suggest that, in the last two years, from 2,000-3,000 raids have occurred against major corporate entities. In essence, the money (or to be blunt, bribes) reportedly paid for court decisions and for the passivity of law enforcement officials, which facilitates the raids, undermines the country's entire system of rule of law.

During a telephone conference call on 28 October, former (and likely future) Finance Minister Viktor Pynzenyk (BYUT) identified both arbitrary regulations and corporate raiding as the largest detriments to foreign investment in Ukraine. "The goal [of the new government] is to give all investors access, and we would also like to introduce legislation to prevent further spreading of raiders' attacks, against which ordinary investors are defenseless." (16)

Despite all of these concerns, foreign investors continue to express interest in Ukraine, and the economy continues to perform well, given the pressures on it, growing at least 6% per year. The number of small and medium businesses in the country is steadily increasing, as they generally are untouched by the battles raging over Ukraine's largest assets, while market mechanisms show signs of taking root in many sectors.

Cardinal Resources' Robert Bensch said he is "encouraged" by the country's prospects. Most who have suffered losses because of arbitrary decisions or unworkable fees also seem to believe that these issues can be addressed, even though valuable time and momentum already has been lost. Large investors say they are waiting, but not turning away. It will be up to Ukraine's next government to ensure that this optimism is not misplaced.

Source Notes:

- (1) Bensch telephone interview with author, 26 Oct 07.
- (2) *Ibid.*
- (3) *Ibid.*
- (4) *Ibid.*
- (5) Taras Kuzio, "Yanukovych and gas price capping," Kyiv Post, 15 Aug 07.
- (6) Interview with Robert Bensch by Morgan Williams, US-Ukraine Business Council, in the Action Ukraine Report, 12 Aug 07.
- (7) Bensch, *ibid* and Kuzio, *ibid*.
- (8) Bensch, *ibid*.
- (9) Dragon Capital, Ukrnafta: Ukraine Equity Guide, May 07.
- (10) Zeyno Baran, "Energy Reform in Ukraine: Issues and Recommendations," The Nixon Center, Mar 05.
- (11) Concorde Capital, Ukrnafta: Under Review Alert, 29 Oct 07.
- (12) Bensch, *ibid*.
- (13) "Contract with Investors," Yulia Tymoshenko, Investor/Press Event, Kyiv, 10

Sep 07.

(14) Bloomberg, 1153 EDT, 19 Oct 07 via www.bloomberg.com.

(15) "Corruption, Democracy and Investment in Ukraine," Policy Paper, The Atlantic Council of the United States, Oct 07.

(16) Conference Call with Viktor Pynzenyk, hosted by Concorde Capital, 28 Oct 07.

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