

Management Report

SECURITY OF SUPPLY

Security of natural gas supply in the 2022/2023 heating season

The 2022/2023 heating season probably will be the most difficult in Ukraine's history due to massive missile attacks from the Russian Federation on Ukrainian energy facilities.

Since Naftogaz traditionally plays an important, if not the key role in ensuring security of natural gas supply – the main source of energy for heating in Ukraine, preparations for this heating season in wartime conditions have had a decisive influence and continue to influence Naftogaz's ongoing activities.

Concurrently, it is important to understand correctly Naftogaz's obligations to ensure meeting the demand for natural gas. The Law of Ukraine "On the Natural Gas Market" assigns responsibility for the security of gas supply, primarily, to the Ministry of Energy of Ukraine, the NEURC (Regulator), and the GTSOU. Consequently, they all possess necessary powers for this. In parallel, Naftogaz, as the market leader, acting within its corporate and social responsibilities, de facto ensured security of natural gas supply, for example, during the previous heating season.

Note that with the onset of a full-scale war, for subjective and objective reasons, the Government assumed even more responsibility for security of supply and received even more powers. It should also be taken into account that due to these reasons the company's capabilities were severely limited.

To the best of its ability, Naftogaz continues to play an important role in ensuring the security of natural gas supply. However, it is important to consider the legally defined obligations of the company in this area. Thus, Ukrainian laws stipulate that the Government can impose a public service obligation (PSO) on Naftogaz to supply of natural gas to consumers in Ukraine only if these obligations are not excessive and do not result in losses that are not compensated by the state.

Natural gas resources for the heating season

As of the date of approval of these unaudited condensed interim consolidated financial statements, natural gas reserves in Ukraine's underground gas storage facilities amount to approximately 14.7 billion cubic metres (bcm).

Alongside the current production levels, it may be enough to get through the heating season under normal weather conditions and if the situation in the energy sector does not deteriorate, especially in power generation. On the other hand, because of the war, it is logical to expect problems and be prepared for them.

We note that Naftogaz, in its plans submitted to the Government back in August 2022, specified that due to gas production in Ukraine and the company's own funds for import, it is possible to reach the level of 14 billion cubic metres of natural gas in UGS by the beginning of the heating season. Consequently, the company has successfully completed these plans in preparation for the heating season.

In addition, the company planned to import 1 billion cubic metres of natural gas before the beginning of the heating season at the expense of the attracted loans and, thus, reach the level of 15 billion cubic metres of gas. The company's management understood that the company would be able to attract loans to pay for the relevant sums. To this end, the necessary work was carried out with potential creditors –

international financial institutions; governments of the countries that provide financing through multilateral financial organizations; and a related communication campaign was also conducted.

At the same time, by its decision dated 17 June 2022 (Resolution No. 691), the CMU determined 19 billion cubic metres to be the level in the UGS by the beginning of the heating season, necessary for a stable passage of the autumn-winter period in 2022/23. Naftogaz, both before and after the formalisation of these plans, without disputing the validity of the Government's decision, based on results of communications with international partners regarding financial assistance to Ukraine, drew the Government's attention to the fact that the implementation of these plans is possible only at the expense of funds that the Government would attract from international partners and assign to Naftogaz. The company also noted the difficulty of attracting the necessary funds by the Government for the required time period.

In addition, the company drew Government attention to the fact that due to the consequences of the Government's decision not to grant permission to pay company Eurobond holders and the relevant next steps of the Government in this area, some of which are listed below, Naftogaz would lose the aforementioned opportunity to attract loans, and therefore all financing should be done at the expense of state budget funds.

Since the time of the Government's adopted resolution, Naftogaz has not received funding from the state budget.

Concurrently, from June–September 2022, the total deductions of Naftogaz to the state budget amounted to UAH 22.6 billion (dividends of UAH 1.9 billion, rents of UAH 13.2 billion, income tax of UAH 0.8 billion, and value added tax of UAH 5.1 billion). The volume of natural gas imported at the company's own expense for the period of June-October 2022 amounted to 0.2 billion cubic metres at a total cost of UAH 14 billion.

Noting that the aforementioned plans of the company to attract loans for financing imports before the beginning of the heating season in the amount of 1 billion cubic metres, which were not realized due to the Government's decision not to grant permission for payment of the Eurobonds, were based in particular on conditions within the European market. Thus, according to the company's calculations, in accordance with the date of this report, the import of this volume of natural gas for winter delivery will cost approximately UAH 19 billion more than it would have in June 2022.

In September 2022, the CMU decreased the planned indicator for the minimum amount of natural gas to be stored in underground storages before the beginning of the 2022/23 heating season to 14.5 billion cubic metres.

Given that as of the date of this report, natural gas reserves in UGS exceed 14.5 billion cubic metres, this plan of the Government has been fulfilled. The Prime Minister noted regarding the accumulated volumes of natural gas in UGS facilities: "it is absolutely enough to sustainably pass this winter"¹

Note that the Government's plan also provides for the import of natural gas in the amount of 3 billion cubic metres during the period from November 2022 to March 2023. At current European market prices, the value of these imports will range between USD 4-5 billion.

Without financing from the state budget "indirect subsidies" to consumers, as mentioned below, and without additional loans, Naftogaz will be able to import close to 0.4 billion cubic metres of natural gas.

¹ <https://www.ukrinform.ua/rubric-economy/3599508-v-ukrainskih-pidzemnih-shovisah-dostatno-gazu-dla-opaluvalnogo-sezonu-smigal.html>

Although the company returned to profitability in 2021 after losses in 2020, full-scale military hostilities led to losses in the first quarter of 2022. Starting from the second quarter of 2022, the company has already become profitable again despite the ongoing war, but this profit still does not allow the company to provide “indirect subsidies” at its own expense to all consumers in accordance with the decisions made by the state without receiving compensation stipulated by law from the state budget. Note that the “indirect subsidies” arise in particular from the difference between the price of imported gas and the sale price, as well as from the supply of natural gas without full and timely payment (see page 85 of the Extended Presentation of the 2021 Annual Report).

At the same time, consequences from the war and the Government’s decision regarding the non-granting of permission for payment of the Eurobonds is the limited impossibility for the company to attract loan funds and thus finance natural gas imports.

We note that in June 2022, the Company concluded a EUR 300 million agreement to finance imported gas, but only on 11 October 2022, the Company received a message from the EBRD concerning the possibility of starting the disbursement of funds. The delay was caused by the fact that the deal required approval by the Government, as well as the below-mentioned restructuring of the company’s Eurobonds, which among others, the EBRD is a holder.

Naftogaz is currently negotiating the attraction of new loans from international financial organizations, while in the amounts are significantly smaller than anticipated in Government’s plans. Note that according to management opinion, obtaining these loans depends to a large extent on the Government’s decisions, such as appointment of a supervisory board in accordance with corporate governance practices, beginning of settlements from the state budget regarding the compensation of “indirect subsidies” to consumers, a return to the implementation of reforms, in particular aimed at rational consumption of natural gas and financial sustainability of the energy sector.

Import of additional natural gas volumes (which is the major part of the import amounts planned by the Government) is possible, if the Government complies with the laws on compensation of “indirect subsidies” to consumers: attracts funds from international partners, and out of these funds provides Naftogaz, DHCs, gas supply enterprises and DSOs compensation for the difference between the tariffs determined by the state and economically justified ones, compensation for the “PSO” imposed by the Government, compensation for “war losses”, etc.

Measures to considerably reduce consumption

Law No. 2479 established a moratorium on increasing natural gas prices and tariffs for heat energy and related services. Concurrently, the Government should compensate for “indirect subsidies” to consumers. At the same time, the Government has not yet provided compensation, although the company began faithfully fulfilling the PSO imposed by the Government on Naftogaz to provide consumers with “indirect subsidies” beginning in March 2022. Currently, there is no information regarding the Government’s attraction of funds from international partners to a dedicated state budget fund or assurances from international partners regarding the provision of such financial assistance in full.

In view of the risk of the state not fulfilling its obligation to provide compensation, Naftogaz assumes that “indirect subsidies” to consumers are a significant economic problem for Ukraine (see page 85 of the Extended Presentation of the 2021 Annual Report).

In addition, the company believes that the effect of indirect subsidies is to distort economic incentives, leading to inefficient consumption. For example, when the price of natural gas set by the state is considerably lower than the market price, and at the same time the price of alternative energy sources,

such as, for instance, wood, is a market one, then there is a distorted economic incentive to consume gas.

At the same time, the company sees a potential here for cutting down inefficient natural gas consumption. Empirical data used by the company also confirms the significant elasticity of demand for natural gas.

Analysis by Naftogaz shows that with liberalised pricing, the price that will balance out the supply and demand in the wholesale market can be expected at “export parity”, which would match the price level in the “perfect competition” environment. However, the competition will be limited in the retail market, at least in some regions. Because of that, the AMCU can be expected to regulate the mark-up for Naftogaz and other dominant players in the regional markets to reach the “export parity”. It can also be expected that the NEURC or the Ministry would determine the requirements for the supply of an “annual” product. At the same time, Ukrgasvydobuvannya, a Naftogaz Group entity, could sell all the produced gas on the exchange (“gas release” program). Note that the Ministry of Energy actually came up with this proposal in January 2021.

According to data available to the company, the biggest barrier to market reforms is the unpopularity of price increases, major ones especially, which would be inevitable under conditions of fair market pricing, even in the case of targeted monetised subsidies given to those unable to pay the market price. And politicians were forced, at least until now, to follow the will of voters.

Therefore, administrative measures aimed at reducing consumption would perhaps be a more politically acceptable alternative to economic incentives (the most effective of which are price signals in case of market pricing) in the first stage.

For example, these measures could include legislative requirements to create an alternative to natural gas in DHCs (except during peak loads). The alternative can include heat pumps, agricultural biomass, household waste, wood, etc. This said, replacement and weatherproofing of networks will enable major heat loss reduction, and weatherproofing of housing will make it possible to cut down significantly inefficient heat energy consumption. Additional upside would come from related changes in heat supply design – a larger number of lower-capacity CHPs/boiler houses using different raw materials, which are optimally located in terms of logistics, loss reduction etc. Another important role is played by apartment building co-owner associations (OSBB).

The company’s experience shows that the implementation period for these projects can take between four months to 1.5 years, i.e., the vast majority of cases can have a major impact as soon as the next heating season in 2023/24. Note that these projects’ payback period at the current level of EU gas prices is between several months to half a year. Therefore, they can be prioritised by the state from an economic standpoint and by international partners providing aid to Ukraine.

A number of urgent measures are possible that will help to significantly limit inefficient gas consumption already this heating season. For instance, the state could oblige DSOs to install equipment to limit the physical withdrawal of gas by DHCs, while at the same time limiting the DHCs’ right to receive gas volumes from Naftogaz, GTSOU, and DSOs, for example, in case of overdue debts.

Note that district heating poses the biggest problem from the market reforms standpoint. At the same time, DHCs make up the largest segment on the market (in 2021, DHCs consumed 8.7 bcm).

Individual heating is comparable to DHC in terms of volume, but at the same time it is relatively easier to reform, since the household consumers can switch from natural gas to an alternative by themselves, can weatherproof their housing, etc. Such consumers are also easier to cut off. Therefore, it may be relatively easier for the state to go for market pricing in this segment.

At the same time, for this step to be politically acceptable, on top of the targeted subsidies to those unable pay the market price, the household consumers should preferably be in a position to buy through instalment plans equipment and materials enabling the switch from natural gas to alternative sources, as well as weatherproofing.

In view of the above, the company foresees that one of the possible roles of Naftogaz in Ukraine's cooperation with its international partners could be raising loans, using the funds to purchase technological equipment and materials from manufacturers, and the subsequent instalment sales of those to DHCs, apartment building co-owner associations, and household consumers. The source for repaying these loans would be both instalment payments collected and compensation from dedicated funds of the state budget, where rent and other taxes payable by Naftogaz would go, as well as the return on sales at the market price of "freed-up" gas volumes, i.e., which will not be the subject anymore of "indirect subsidies" to consumers.

Therefore, in all other market segments, the state could turn to market pricing, in particular by lifting the ban on domestic natural gas exports.

Note that the current laws of Ukraine have almost completely limited the possibility of cutting off any household consumers from gas and heat supply, charging penalties and late payment fees, forced debt collection.

In turn, this also limits the positive impact of market pricing or the administrative measures mentioned above. Therefore, the company is in favour of amendments to the laws that would make these restrictions selective and more reasonable.

Another necessary step to secure financial discipline and minimise manipulations on the gas market that lead to, in particular, inefficient gas consumption, are legislative changes that would enable the regulator to introduce temporary administrations in DSOs and CHPs, and which would bring the secondary legislation on the gas market regulations, in particular, the TSO Code, in full compliance with the EU standards.

FINANCING

Default

In July 2022, Naftogaz defaulted on Eurobonds, because the Government, acting as the highest governing body of the company – the General Shareholders Meeting, did not allow the scheduled payment of the principal debt and interest.

Before the scheduled Eurobonds maturity date, the company's management analysed the current liquidity of Naftogaz and its ability to raise additional financing necessary for gas imports, and came to the conclusion that the probability for a successful restructuring is low, and that the start of restructuring will negatively affect its ability to both raise additional financing and use the financial resources available. However, the Cabinet of Ministers issued Resolution No. 554-p dated 7 July 2022 and obliged management to launch negotiations with Eurobond holders to enable restructuring on the terms specified by the resolution.

Therefore, before the maturity date of Eurobonds' Tranche B, based on the decision of the Government the company initiated the process of restructuring its Eurobonds. Government representatives took part in the negotiation process with the bondholders, but consent from the bondholders was not received.

After that, the Cabinet of Ministers of Ukraine issued Resolution No. 625-p dated 21 July 2022, according to which management was prohibited from taking any actions related to implementation of the Eurobonds-related agreements without prior approval by the Cabinet of Ministers of Ukraine. In addition, the Government noted in this resolution that the restructuring process was unsuccessful due to the unsatisfactory performance of the company's executive board and obliged the company's management to launch a new restructuring process on government-defined terms.

We note that company management was not provided with any substantiation for recognising the executive board's performance as unsatisfactory. As already mentioned, the management acted only to implement the Government's decision regarding the terms of restructuring. That said, the analysis by the management leads to the conclusion that it was not possible to solicit the consent of Eurobond holders, in particular, because most of them believe that Naftogaz's Eurobond debt could have and should have been repaid from a rational standpoint, unlike the sovereign debt and sovereign-guaranteed debt.

The company's management requested Government to approve payments to fulfil its Eurobonds obligations, and pointed out, in particular, the following negative consequences of default and new attempts at bond restructuring:

- the company practically simultaneously could attract an EBRD loan for approximately the same amount as the Eurobonds repayments, but at a lower interest rate; the company was also holding negotiations to attract other loans from international financial organizations, also at a lower rate; the default would limit company abilities to attract new loans; in turn, it will prevent the company from importing additional gas volumes at lower prices during the summer that would be stored in the UGS facilities before the heating season;
- risks of lawsuits from the Eurobond holders, particularly those lawsuits pertaining to the company's assets.

Government did not approve of the repayments, while resolution No. 670-p dated 01 August 2022 obliged management to continue the consent solicitation process for the lenders to restructure the debt on new terms set out by the Cabinet of Ministers of Ukraine.

As before, Government representatives took part in the negotiation process with the Eurobond holders.

The lenders did not approve the restructuring of USD 335 million for the 2022 Eurobonds. At the same time, voting results were even worse than the first time. We should note that the restructuring of this Eurobond tranche was the most crucial for the company, as this tranche provided for the largest payments in 2022.

Also, the lenders did not approve the restructuring of USD 500 million, the maturity which would have taken place in 2026.

At the same time, on 31 August 2022, the lenders approved the restructuring of UAH 18,467 million with a term of payment in 2024, and accrued interest amounting to UAH 1,317 million (the Loan Agreement dated 17 July 2019, EUR 600 million Tranche A and the interest under Tranche A). Note that the major holder of this Eurobond tranche is the EBRD.

The management is currently preparing new proposals for lenders pertaining to the Eurobonds, the approval for the restructuring of which was not secured. These proposals require approval of the Government. According to company management, a significant positive impact on Eurobond restructuring might also be gained from the appointment by Government of an independent Supervisory Board for the company and a return to implementing Government reforms aimed at efficient consumption and transparent functioning of the domestic gas market.

Besides, during the second half of 2022, the company received waivers from Ukrainian banks regarding non-application of the right to demand early repayment of loans in the amount of UAH 15,605 million due to the occurrence of a cross default.

Laws on providing compensation from the state budget (“indirect subsidies” to consumers)

In July 2021, the Verkhovna Rada of Ukraine adopted Law No. 1639 “On Measures to Overcome Crisis and Ensure Financial Stability in the Natural Gas Market”. This law provided for receiving compensation for the negative difference between the actual heat tariffs and their economically justified level for heat generating companies and further repayment of their overdue debt to Naftogaz. In December 2021, the company received UAH 22 billion, as a result of the implementation of this law.

A similar settlement mechanism was provided for by the law for regional gas supply and gas distribution companies with further repayment of their overdue debts to Naftogaz.

In order to ensure the protection of consumers in Ukraine against cost increase for natural gas, heat supply and related services in the circumstances of the military aggression against Ukraine and ensuring sustainable passage of the 2022/2023 heating season, Law of Ukraine No. 2479 dated 29 July 2022 “On Peculiarities Of Regulation Of Relations In The Natural Gas Market And Heat Supply Sector During The Martial Law And Subsequent Restoration” was adopted.

The law provides for:

- introduction of a moratorium on the increase of natural gas prices and tariffs for heat energy and related services;
- compensation for the difference between the state-determined and economically justified tariffs;
- compensation for the difference between the cost of natural gas (including imported gas) and this gas sales price determined by the state;
- compensation for non-payment by consumers, “PSO” regarding gas supply imposed by the state;

- compensation for “war losses” to DSOs and DHCs.

Implementation of Law No. 1639 and Law No. 2479 should become one of the steps to settle the structured problems of Ukraine’s gas market, in particular, in terms of ensuring a qualitatively higher level of transparency of state financing of indirect subsidies to gas consumers. In addition, these laws allow settling most of the debt problem in natural gas market caused by loopholes in the state regulation of the market during past periods.

Read more about the company’s position regarding “indirect subsidies”, in particular, about the reasons and consequences of their provision, on pages 84–87 of the Extended Presentation of the 2021 Naftogaz Annual Report.

Law No. 2479 was signed by the President of Ukraine and came into effect from 19 August 2022.

On 12 October 2022, Resolution of the CMU No. 1179 approved the Procedure of settlements for gas supply companies and DSOs aimed at implementation of Law No. 2479. The Procedure on settlements with DHCs and the Procedure for reimbursement of expenses incurred due to the performance of the imposed PSO are still under development.

In accordance with the above normative legal acts, according to the calculations made by Naftogaz, in 2022, the Company should receive:

- UAH 76 billion from gas supply companies and gas distribution systems operators, and UAH 14 billion from DHCs, which in turn should receive these funds from the dedicated fund within the state budget as compensation for “indirect subsidies” to consumers. These funds should be dedicated to the special state budgetary fund from Naftogaz, as a prepayment for dividends (UAH 64 billion) and income tax (UAH 12 billion), which is calculated according to dividend payments, and the rest – at the expense of international financial assistance.
- UAH 49 billion and UAH 78 billion from the special state budgetary fund as a compensation for PSO in March–September and October–December 2022, respectively. In addition, the Government should attract funds from Ukraine’s international partners to this dedicated state budget fund. The amount provided for the specified compensation in the state budget currently adds up to UAH 111 billion, however, according to the legislation, this indicator may be reasonably increased.

Nevertheless, the probability of attracting resources to the special state budgetary fund for the above compensations depends significantly on the ability of Ukraine to keep receiving international diplomatic and financial assistance.

As of the date of approval of these unaudited condensed consolidated interim financial statements, Naftogaz has not received the specified compensation.

Should the Government fulfil its obligations under the law to provide the specified compensation, according to the management plans, Naftogaz will be profit-making based on 2022 results.

Note that based on the management’s estimate, it will cost the company approximately UAH 104 billion to implement the PSO in January–March 2023, but in order to receive the compensation for this, it should be foreseen within the Law On The State Budget Of Ukraine in 2023. Currently, it is not provided for by the draft of this law adopted by the Verkhovna Rada in the first reading, but the company is cooperating with the Government and members of the Parliament on introducing relevant amendments.

Note that Naftogaz actively cooperates with the Government on searching for additional options to replenish the special state budgetary fund. Thus, one of the additional sources of replenishment of the special budget fund could be rent payments and other taxes payable by Naftogaz during 2022-2023.

Also, Naftogaz actively works, in particular, in cooperation with the Government, to reduce inefficient gas consumption and, respectively, the state expenses for compensation from the budget.

Failure of local budgets to fulfil their obligations to compensate for the difference in tariffs

In September 2021, a Memorandum of Understanding was concluded on the settlement of problematic issues pertaining to heat energy supply and hot water supply in the 2021/2022 heating season (the “Memorandum”).

According to the Memorandum, tariffs for heat energy were not increased and remained at the level of the previous 2020/2021 heating season.

The company thoroughly fulfilled its part of the obligations, in particular, on ensuring uninterrupted supply of natural gas to DHCs during the 2021/2022 heating season.

At the same time, the majority of local authorities (the “LA”) neither fulfilled the conditions of the Memorandum nor provided compensation envisaged by the Memorandum to DHCs during the 2021/2022 heating season, as well as after its completion. That became one of the reasons for increase of the debt to DHCs for natural gas and problems with the financing of preparation measures for the upcoming heating season.

The estimated amount of the debt of the LA only to DHCs, which according to the decision of the Government should be included into the company’s authorised capital, amounts to UAH 415 million.

At the same time, there is a positive example of the Mykolaiv City Council, which fulfilled the conditions of the Memorandum by fully financing the needs of PJSC Mykolaiv CHP in the amount of UAH 81 million. Therefore, the local authorities are able to fully or at least partially fulfil conditions of the Memorandum to allocate the funds from the local budgets to DHCs, which in turn will give DHCs the opportunity to reduce debt for natural gas.

Given the above, the Company is planning to address a proposal to the Cabinet of Ministers of Ukraine to obligate local authorities to execute the conditions of the Memorandum and allocate the funds from local budgets to compensate heating companies by the end of 2022.

AREAS OF ACTIVITY

Production

Naftogaz maintains stable production of natural gas and liquid hydrocarbons at all facilities, except for some facilities located in temporarily uncontrolled territory. Based on the latest forecasts, the natural gas production of JSC Ukrigasvydobuvannya (hereinafter referred to as commodity volumes, not gross volumes of gas) in 2022 is 12.5 bcm of gas compared to 12.9 bcm in 2021 (the actual production for H1 2022 made 6.3 bcm compared to 6.4 bcm in H1 2021).

Gas production from a certain well may be temporarily suspended for a certain period (in case of emergency) and resumed once production is safe again. Emergency well shutdown has a negative impact on the volume of gas and liquid hydrocarbons production. In order to reach pre-shutdown figures, production stimulation is required. Each well separately from those at risk of emergency shutdown in Kharkiv region has insignificant flow rates, therefore such shutdowns will not have a dire impact on the activities of Naftogaz companies.

JSC Ukrigasvydobuvannya, as part of Naftogaz, demonstrates far better production performance than other production companies in Ukraine during the war, with a decrease in natural gas production over 9 months in 2022 compared to the same period last year amounting to 2%, while other production companies had a total decrease of 11%.

Note that if Naftogaz reduced production as private companies, it would mean, in annual terms, a decrease in production by an additional 1.2 billion cubic metres. In turn, to meet the needs of Ukrainian consumers this winter, this volume (under otherwise similar circumstances) would have to be imported and based on the current import prices that would cost about USD 1,5-2 billion. By maintaining production at this level, Naftogaz makes it possible for the company and the state to achieve significant savings on gas imports.

The volume of natural gas production, among other things, depends on the operating modes of the Gas Transmission System of Ukraine. In the case of zero transit, the GTSOU is expected to change the operating modes focusing on supporting the production of Ukrainian gas by ensuring optimal operating pressures in the system (Draft Law No. 6133), which will have a positive effect on natural gas production of about 150 million cubic metres per year.

To ensure the quality of commercial gas in line with the requirements of the TSO and DSO Codes, Naftogaz developed the Gas Treatment Concept in 2020-2021 and launched measures to improve the quality of natural gas.

At the same time, the close proximity of the production facilities of the eastern region to the area of active combat activities and their partial occupation had a negative impact on the implementation of the above concept.

Over 9 months of 2022, JSC Ukrigasvydobuvannya paid more than UAH 200 million in fines for non-compliant commercial gas transmitted to the Gas Transmission System. However, such penalties were not redirected as compensation to ultimate consumers due to the fact that such a mechanism is not provided for by the laws. Instead, fines for non-compliance with gas quality parameters reduce the financial resources of Naftogaz, which could be used to boost production.

Despite the repeated shelling of units, interruptions in electric energy supply, difficulties in attracting contractors, and the need to optimise financing, Naftogaz continues to implement plans to re-equip production facilities and diversify gas flows to ensure the preparation of marketable products in accordance with the requirements of the applicable regulations.

As a result of the successful counteroffensive of the Armed Forces of Ukraine in September 2022, the number of temporarily occupied territories of Kharkiv region, where a significant part of Naftogaz's production facilities are located, has significantly decreased. Gradually, Naftogaz personnel are gaining access to de-occupied production facilities, assessing the damage caused, and working on production restoration. Currently, about 15 facilities are awaiting demining and restoration, which will require, according to preliminary estimates, UAH 1 billion of additional expenses. Additional natural gas production, as a result of the restoration of the facilities, is expected to be over 1 million cubic metres per day.

In December 2021, Law of Ukraine No. 1977 on creating preconditions for sustainable development and modernisation of domestic industry was adopted, which entered into force in July 2022. This Law prohibits state customers from purchasing engineering goods that do not have a confirmed localisation degree. Among the list of relevant products subject to these restrictions are generators, transformers, compressors, pumps, machines and vehicles which are of critical importance for oil and gas companies to run efficiently, and now also to provide backup power source at critical infrastructure facilities. While at the time of adoption of the Law last year, there were hopes that the new requirements would encourage international companies to locate the production here, now it is quite the opposite – even domestic companies are often forced to temporarily relocate their production to the West. Accordingly, apart from all existing problems and risks regarding a number of critical equipment and transport, a new problem of the absence of the suppliers or significant restrictions imposed on the suppliers who are ready to confirm the required level of localisation has now appeared, which also complicates (and in some cases makes impossible) procurement performance in line with the applicable rules and procedures.

Despite the domestic market U-turn resulting from martial law when most foreign suppliers, as well as a significant part of domestic companies, have suspended their activities, logistics capabilities have become significantly complicated. There are foreign exchange risks and constant price changes, while the vast majority of public procurement is still subject to the usual rules and procedures under the Law of Ukraine "On Public Procurement". For major Naftogaz companies, this means that the procurement procedure takes, on average, three months. Such conditions almost always lead to the impossibility of entering into contracts in a timely manner, which significantly reduces the opportunities for maximum gas production and jeopardises the heating season.

Supply

“Supplier of last resort”

Since the Company was designated by the Government as a “Supplier of last resort” (SLR), the list of consumers to whom SLR provides natural gas was unilaterally expanded by the Regulator (NEURC), in comparison with the list of SLR consumers determined by the conditions based on which the Company participated in the “Supplier of last resort” tender. In particular, the Regulator (NEURC) made decisions that enabled the transmission system operator (GTSOU) to attribute to the Company withdrawals of gas made by gas distribution system operators (DSOs) and district heating companies (DHCs) that do not have a supplier.

The above decisions of the Regulator and GTSOU enabled the specified companies to use natural gas practically in unlimited volumes and free of charge. Inappropriate incentives were implemented which, had a negative impact on financial discipline in the market.

It should be mentioned that this does not correspond to established European practices, where the “Supplier of last resort” mechanism is a kind of insurance for consumers which provides a possibility for the short period necessary to search for a new supplier to assuredly receive gas, albeit at above-market price (which in turn is an economic incentive to find a new supplier).

In the management’s view, the next step to ensure financial discipline in the gas market is for the Regulator to make key changes to regulations: to ban GTSOU from automatically including non-household consumers in the register of SLR without the SLR’s consent; withdrawal of gas by DHCs and DSOs (beyond the limits established in the agreement with GTSOU) without the presence of a supplier should be considered unauthorised withdrawal followed by severe sanctions (above-market price, license cancellation, etc.). Note that further disregard of the above situation will lead to deepening of problems on the natural gas market.

Gas supply for power generation companies

As part of its day-to-day activities, Naftogaz supplies relatively small volumes of gas to power generation companies. In H1 2022, these volumes amounted to 0.6 bcm. The main reason for the supply of gas to power generation companies is the fulfilment of the PSO imposed upon Naftogaz by the Government.

Natural gas was supplied at prices significantly lower than the cost of imported gas.

At the same time, the problem of a low level of payment for natural gas, even supplied at below-market prices, is significant. Currently, laws provide for a mechanism for compensation of losses incurred by Naftogaz when performing PSO to supply gas to power generation companies; however, there is no procedure for calculating and verifying the corresponding amounts.

As of 30 June 2022, the total amount owed by power generation companies to Naftogaz for gas supplied within the scope of PSO is UAH 3.1 billion.

Among other things, the GTSOU violated the order of the Ministry of Energy of Ukraine and included Zmiiv heat generation station (a branch of PJSC “Tsentrenergo”) in the Register of consumers of the “Supplier of last resort”, which enabled PJSC “Tsentrenergo” to withdraw natural gas from the Company totalling UAH 2.4 billion free of charge.

The above highlights significant problems in the electricity market: the tariff for the ancillary services to ensure regulation of frequency and active capacity in the energy system of Ukraine and price caps do

not fully cover all costs; protracted Ukrenergo settlements with power generation companies result in an unsatisfactory financial condition of power generation companies.

At the same time, the Government estimates that in order to meet the needs of power generation, about 3 billion of cubic metres of gas is needed for the upcoming heating season.

Considering the financial problems of power generation companies, Naftogaz cannot supply gas without prepayment and debt repayment. The current problem requires the Government to react, not to pass issues on to Naftogaz. Changes in the regulatory environment of the electricity market, which will allow power-generating companies to cover their costs, as well as to reduce inefficient electricity consumption, are possible solutions to the problem.

Gas transit

The provision of services for the organisation of gas transmission to European countries continues. However, since the beginning of the year, volumes have significantly decreased compared to last year – for H1 2022, the volumes of transmission made 12.7 bcm compared to 21.7 bcm in the relevant period of 2021.

Due to military aggression and active hostilities in the eastern region of Ukraine, GTSOU declared force majeure circumstances at one of the two entry points to GTSOU. At the same time, the customer transmission services (Gazprom) limits physical volumes of transmission, refuses to switch gas flows to another entry point that has excess technical capacity, and reduces payment amounts for the Company's services.

In September 2022, the Company appealed to the Court of International Arbitration with a debt recovery claim from PJSC Gazprom for the provision of services for the organisation of natural gas transmission through the territory of Ukraine. PJSC Gazprom then threatened that it may impose sanctions on Naftogaz.

Subsequently, on 26 September 2022, an accident occurred at Nord Stream 1 and Nord Stream 2 gas pipelines, and gas supply to European consumers is not taking place at this time. In addition, on 1 October 2022, Gazprom stopped supplying gas to Italy due to regulatory changes in Austria. At the same time, on 6 October 2022, gas transit through the territory of Austria was resumed.

Considering the above, there is uncertainty regarding the continuation of natural gas transit through the Ukrainian transmission system, as well as regarding payment for the services rendered in the organisation of natural gas transit.

Gas storage activities

As part of preparation for the heating season, Naftogaz is holding a number of activities aimed at preparing underground gas storage facilities and the corresponding infrastructure for the autumn-winter period. Ensuring the reliability of infrastructure functioning primarily depends on sufficient coverage of economically justified costs on account of the tariff established by the Regulator (NEURC).

Despite the insufficient tariff coverage of all economically justified costs, Naftogaz ensured readiness for the heating season in a timely manner.

Naftogaz has determined the main directions for the financial stability of the operator of underground gas storage facilities: to cooperate with the Regulator on raising tariffs to an economically justified level and optimise underground gas storage facilities taking into account the volumes of gas required for storage.

On Naftogaz's initiative, starting from 1 July 2022, tariffs for storage services (injection, withdrawal) of natural gas for gas storage facilities of JSC Ukrtransgaz have been increased: the total annual tariff increased by 164.5% (for storage – by 110.5%; for injection – by 121.1%; for withdrawal – by 299.0%). However, to ensure the target level of return on invested capital (19%), tariffs for underground gas storage services should be additionally increased 3.9 times from the current level. Since October 2022, the Company has intensified drafting of the regulatory framework for changing the methodology for calculating tariffs for storage, injection, and withdrawal services based on multi-year incentives and setting the RAB tariff.

Moreover, throughout 2023-2024, it is planned to develop a feasibility study and relevant legislative changes regarding the decommissioning of a part of gas storage facilities, the use of which is economically and technically impractical, as well as to free up buffer and residual gas reserves of at least 1.96 bcm. Proximate capacity optimisation is expected by 31 December 2031.

Preparation of DHCs for the autumn-winter period

Pursuant to CMU Resolution No.857 dated 11 August 2021, it was resolved to transfer blocks of shares of such DHCs as JSC “Dnipro CHP”, JSC “Kryvyi Rih HP”, PrJSC “Mykolaiv CHP”, JSC “ODESA CHP”, JSC “Kherson CHP”, and SE “Sievierodonetsk CHP” to the share capital of National Joint Stock Company “Naftogaz of Ukraine”.

In pursuance of the Government’s instruction, the Company developed and implemented an Action Plan to Prepare Combined Heat and Power Plants for Timely Start and Stable Passing of the 2021/2022 Heating Season. It was also resolved to provide interest-free loans to CHPs not exceeding UAH 2,908 million. At the date of these financial statements, the actual arrears on loan facilities granted to CHPs is UAH 557 million.

Measures taken during the 2021/2022 heating season made it possible to reduce natural gas losses at the above-mentioned CHPs by 84 mmcm in comparison with the previous heating period. The market value of these gas resources exceeds UAH 3.2 billion. Management believes that the measures taken have contributed to the timely start of preparation of CHPs for the 2022/2023 heating season.

At the approval date of these unaudited condensed consolidated interim financial statements, heat-generating companies of Naftogaz are 100% ready for the heating season. JSC “Kherson CHP” and SE “Sievierodonetsk CHP” are located in the temporarily occupied territories of Kherson and Luhansk regions.

Cost-cutting measures

Considering the Russian Federation's military aggression and war-related challenges, Naftogaz has taken the following measures to cut costs:

- the Executive Board adopted the relevant resolutions on, and strengthened control over and monitoring of, the use of Naftogaz's funds; the Executive Board also defined the list of critical cost items for each of Naftogaz subsidiaries being financed during martial law to ensure the stable operation of Naftogaz subsidiaries;
- operating expenses and capital investments in the financial plans of Naftogaz legal entities were reduced to the minimum efficient scale of production. Those capital investments that do not directly affect the 2022 operating activities and that are not made to meet the legislative requirements, in particular on HSE issues, were postponed for the future periods following 2022;
- despite the fact that the NBU raised the discount rate by 2.5 times (from 10% to 25%) and the cost of financial resources on the Ukrainian financial market significantly increased, the management of National Joint Stock Company "Naftogaz of Ukraine" held negotiations with creditor banks and reached agreements to postpone maturity dates of loans for over UAH 9 billion for future periods and to maintain the value of credit resources at the level lower than the weighted average cost of loans among state non-financial corporations of Ukraine;
- at the initiative of Naftogaz, the National Bank of Ukraine adopted a decision that allowed for early repayment of cash securing the bank guarantees from coverage accounts of UAH 5.4 billion, which significantly increased the available working capital of Naftogaz;
- tax liabilities related to the rent for subsoil use for natural gas production owed by JSC UkrGasvydobuvannya in the amount of UAH 4.25 billion were postponed;
- advance tax payments and/or overpayments recorded in Naftogaz tax cards of UAH 15 billion were used and credited as payment of current tax liabilities. This made it possible to significantly reduce the burden on the working capital of Naftogaz;
- at the initiative of Naftogaz, the Cabinet of Ministers of Ukraine resolved to make changes to the allocation of the net profit of National Joint Stock Company "Naftogaz of Ukraine" for 2021, which allowed to direct 65% of the Company's net profit to the purchase of natural gas to be used during preparation for the 2022/2023 heating season;
- a decision was made to cut the remuneration of Naftogaz management by 70% and to stop accruing and making incentive payments to the employees.

Transfer of corporate rights and assets of LLC “GLUSCO UKRAINE”, LLC “GLUSCO RETAIL” and other related organisations under Naftogaz’s management

In May 2022, by Instruction No. 385-p, the Cabinet of Ministers of Ukraine resolved to transfer 100% of the corporate rights and assets of LLC “GLUSCO UKRAINE”, LLC “GLUSCO RETAIL” and other related persons (Naftogaz “Glusco”) under Naftogaz’s management. Pursuant to Instruction No. 385-p, separate agreements were concluded with the Asset Recovery and Management Agency (ARMA) on management of corporate rights and properties, namely 229 items including more than 120 filling stations, construction-in-progress assets, land plots, and property located in different regions of Ukraine, including in the temporarily occupied territories and in the active war zone. The relevant corporate rights transfer and acceptance certificate was signed on 22 June 2022. However, the actual transfer of properties has not been completely carried out. Therefore, as of 30 June 2022, Naftogaz exercises no control over the assets of Naftogaz “Glusco”.

Transfer of corporate rights of regional DSOs under management

In July 2022, Naftogaz entered into an agreement with the Asset Recovery and Management Agency (ARMA) on management of corporate rights of 26 regional gas distribution system operators (DSOs) for a period of 5 years. The corporate rights transfer and acceptance certificates were signed by the parties to the agreements on 5 July 2022. Therefore, as of 30 June 2022, Naftogaz had no control over the regional gas distribution entities.

On 2 September 2022, Naftogaz established a new subsidiary - LLC "Gas Distribution Systems of Ukraine", whose purpose is to be an efficient DSO at the national level. As at the publication date of these condensed consolidated interim financial statements, the share capital in the amount of UAH 250 million was not paid.

LLC "Gas Distribution Systems of Ukraine" plans to lease the necessary systems and to obtain a DSO licence in the territories of Kirovohrad and Donetsk regions by the end of 2022; and to start operating as an operator in 2023. In 2023, LLC "Gas Distribution Systems of Ukraine" plans to become a new operator of the gas distribution systems, which are currently being operated by the above regional DSOs, whose corporate rights were transferred to Naftogaz.