

Ukraine: not out of the woods yet

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Ukraine's energy sector is slowly recovering after many years of barter transactions and chronic non-payments for electricity.

Amendments to the Electricity Law in the summer of 2000 resulted in an average payment rate of 89.4% for electricity by distribution and supply companies to the Wholesale Electricity Market (WEM), 83% of which was paid in cash in 2002. Strict measures taken by the National Electricity Regulatory Commission (NERC) and supported by the Ministry of Fuel and Energy (MFE) are targeted at further increases in collection rates.

However, more fundamental problems with the system of household subsidies and imperfect tariff setting for the municipal utilities mean desired payment targets have still to be reached.

Since the privatisation of regional distributors (Oblenergos) in 1998-2001, when the state sold controlling stakes in 13 out of 27 companies, Oblenergos have been much tougher on non-payers through a policy of disconnection. However, problems still exist with strategic companies such as water utilities and city sewage operators who cannot be cut-off due to the potential negative environmental consequences.

Oblenergo owners are also faced with the problem of significant theft of electricity, and unmetered electricity. Those losses range from between 9-18% of total sales and are largely caused by poor management and obsolete metering systems.

One positive effect of privatisation has been that tariff regulation for Oblenergos has become more transparent. NERC approved and implemented a new method for computation of distribution and supply tariffs based on the principles of rate of return regulation. The new method allows Oblenergos to earn a

reasonable rate of return on invested capital, partially recover commercial losses through tariffs and provides incentives and tools for reduction thereof.

Tariffs for six privatised Oblenergos were approved by NERC at a public hearing between November 2001 and February 2002, setting a precedent as a result of which all tariff cases are now considered by NERC at open public hearings.

Concept of the WEM Development

Ukraine's government initiated reform of the Wholesale Electricity Market last year. The initial objectives were to remove administrative interference in the settlements system, improve inefficient pricing, enhance competition and create a stable market environment attractive to private investors.

A special working group was established and included the representatives of key ministries, energy companies and leading industry experts. As a result, the Cabinet of Ministers approved the Concept of Development of the WEM in November 2002. The government has already developed the Concept Implementation Plan to be announced shortly.

The concept envisages a phased transition from the current single-buyer model to a full-scale competitive market that includes bilateral contracting between generators and suppliers or generators and customers, a balancing market, financial contracts market and ancillary services market.

It is expected that the transition will take five years on condition that certain preconditions are met, such as the introduction of modern commercial metering and data exchange systems, achievement of full payment for electricity, resolution

of sector debt problems, enhancing financial sustainability of energy companies, reformation of pricing mechanisms to ensure full cost recovery and reasonable rates of return on investment.

The bilateral contracts market will develop in parallel with the existing spot market. The introduction of bilateral agreements will be gradual via the following stages:

1. Bilateral agreements between CHPs (irrespective of the installed capacity) and a supplier within whose licensed territory the CHP is located and/or a customer of this supplier;
2. Bilateral agreements between CHPs, thermal and nuclear power plants and a supplier in the amounts established by the NERC and/or a final customer whose annual electricity consumption exceeds 250GWh;
3. Bilateral agreements between CHPs, thermal and nuclear power plants and a supplier and/or a final customer whose annual electricity consumption exceeds 100GWh;
4. Bilateral electricity purchase agreements between CHPs, thermal and nuclear power plants and a supplier and/or a final customer irrespective of electricity consumption volume.

Electricity generated by hydro plants and pumped storage hydro stations, whose capacity or output exceeds marginal levels set by NERC, is to be sold exclusively via the Wholesale Electricity Supplier (Energomarket) and at the balancing market.

The concept suggests that Energomarket be transformed into a balancing market operator after completion of the privatisation of thermal power generators. Control over Energomarket's activity will be transferred from the government to market participants in the course of reform.

Financial contracts for electricity will be introduced to allow hedging of price volatility risks of market participants. The administrative interference into the algorithm of the

funds allocation in the WEM will also be removed through a change to the settlements system. Pricing and tariff setting will be reformed and result in:

- Removal of cross-subsidies between different customer groups;
- Ensuring full-cost recovery and regulated rate of return for nuclear and hydro plants and NEC Ukrenergo (operator of transmission networks);
- Gradual transfer of CHP and nuclear plants to the bidding regime from the current fixed tariffs (currently, only thermal generators operate with competitive bidding);
- Inclusion of nuclear decommissioning costs into the tariffs for nuclear power plants;
- Development of methodologies for pricing the ancillary services.

Sceptics say that the lack of preconditions as well as the high cost of introducing modern metering technologies, hardware and software will lead to delays in the reform of the WEM.

While the role of NERC, the independent regulator, has become increasingly significant in recent times, the MFE still holds considerable influence over the sector through the management of equity stakes in generators and distributors. The state-owned distributors and generators still dominate the board of the WEM, a self-regulatory market association, with only three seats of 10 occupied by representatives of private energy companies.

Privatisation and the debt problem

Privatisation of the remaining state controlled Oblenergos was planned for 2002. The Cabinet of Ministers approved tender conditions for the sale of controlling stakes in nine Oblenergos in July 2002 in its attempts to boost the state budget and fulfil IFIs' conditions. However, the sale has never been launched since the companies are in no state to be sold off with outstanding debts, which as of 1 July 2002 amounted to almost \$1.1bn.

Meanwhile, as of the same date, the WEM owed in excess of \$3bn to the generators causing serious liquidity problems and in some cases bankruptcy proceedings against thermal generators. One such proceeding in April 2001 resulted in a debt-to-equity sale of three of Donbassenergo's power plants, to a private Ukrainian company. The first Ukrainian private generating company Skhidenergo was established on the basis of these plants.

Another factor to delay the privatisation of the oblenergos is the lack of international investor interest in Ukraine's industry, which limits the circle of potential bidders to CIS investors only. This trend is supported by the fact that stakes in six Oblenergos acquired by AES of the US and Slovakia's VSE in 2001 is now being transferred to local investors. Controlling stakes in four distributors purchased by VSE are now managed by the Russian financial group that secured financing for the deal, while AES has indicated its intention to sell controlling stakes in its two oblenergos and is negotiating with potential buyers at the moment. However, AES' decision is as much a result of the company's global corporate problems and has little to do with the performance of the Oblenergos.

The sad truth is that global changes in the energy industry and a decrease in investor interest in emerging markets has coincided with an improvement in the situation of Ukraine's energy sector that would make it attractive for foreign direct investment in other circumstances.

In an attempt to resolve the debt problem, the government developed a Draft Debt Restructuring Law and submitted it to parliament in September 2002. The Draft Law caused controversy since it was feared that electricity prices would need to be increased to cover the sector's debt "overhang" estimated at about \$2bn.

It is expected that the parliamentary Fuel and Energy Sector Committee will further elaborate the Draft Law and that parliament will consider it this year enabling the resumption of

Oblenergos' sales. The methods envisaged in the draft law for debt reduction include mutual debt settlements and offsets, partial write-off of bad debts, debt restructuring as well as financing of the remaining debts. The comprehensive debt-restructuring programme shall be accomplished as soon as possible to prevent bankruptcy and asset stripping.

Privatisation of the country's four thermal power generators also depends on the success of sector debt restructuring. The government may consider different divestiture options alternative to the tender sale of the companies' shares such as sale of individual power plants or creation of joint ventures for rehabilitation of certain assets taking into account the large size of the companies and complexity of their financial situation. MFE officials recently publicly stated that privatisation of CHP plants may be allowed soon if amendments to effective legislation are made. At the same time there are not many CHP plants left for sale since municipalities control many of them. A ban on privatisation of nuclear and hydro power stations as well as transmission network will remain in force for the nearest future.

Ukraine desperately needs to attract investment to rehabilitate worn out assets, especially, generating plant. However, the current single buyer system of the WEM, inefficient pricing and the overall investment climate does not provide enough comfort and predictability for investors.

Investment projects related to the export of electricity from Ukraine remain the most attractive, however, the separate operation of the Ukrainian grid and UCTE significantly limits export potential as well as undeveloped legislative framework for import and export transactions. Currently only two Zakhidnergo plants located in western Ukraine are connected through the "island scheme" to the grids of its European neighbours.

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