

Waiting for guidance

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Despite positive developments in Ukraine over the last year culminating in a new democratic government last December, there has been little progress in terms of power sector reform. The improvement in investment climate has not resulted in further power privatization or liberalization.

The government instead seems to favour strong state control over the country's energy companies and does not seem in any rush to sell further stakes in any of the regional distributors nor begin the sale of the four thermal power generators. Moreover, it would appear that it will launch a review of non-transparent privatizations of several distribution and supply assets that ended up in the hands of local business groups several years ago. Only AES and VS Energy International who purchased a handful of regional distributors in 2001 can be secure, especially given that these companies have restructured their debts to the wholesale electricity market (WEM).

The government is discussing its new energy strategy with special emphasis on ensuring the country's supply independence. Surprisingly, the idea of breaking up the national holding company Energy Company of Ukraine (ECU), established last year by former President Kuchma on the basis of consolidating state power generating and distribution companies, is not on the agenda.

The major discussion instead is focusing on subordinating ECU to the Ministry of Fuel and Energy instead of the Cabinet of Ministers. This further complicates market reform and limits significantly the potential for private sector investment, thus, supporting continued government reliance on loans from international financial institutions such as the World Bank and EBRD to finance construction of new generating and transmission capacity.

Implementation of the WEM Development Concept envisaging transition to bilateral contracts, a balancing market and gradual market liberalization is still underway. However, no concrete steps have been made with work led by a specially appointed intergovernmental commission concentrating to date mainly on theoretical aspects of market reform, and working without a defined timetable and with little apparent enthusiasm.

Another important area where conflicting steps have been taken is in the removal of cross subsidies. Among the first resolutions approved by the new government, a decision was taken to cancel 'privileged' tariffs for two aluminium and titanium plants in eastern Ukraine which benefited from 'special' electricity prices subsidized by other customers. The Minister of Fuel and Energy later revealed controversial cabinet plans to establish single tariffs for customers of each voltage class regardless of their location. Effective "cost plus" tariff methodology provides that customers of each region pay different tariffs based on the costs of the power distributor

company serving their respective region. It is premature to analyse the impact of the proposed single tariff as the mechanism has yet to be approved. Nevertheless, it looks like a step towards stricter government control over electricity pricing that may further reduce the role of the independent regulator – the National Electricity Regulatory Commission – and create an additional obstacle to market opening.

On the plus side is Ukraine's clear course towards European integration as confirmed by President Victor Yushenko. In electricity terms this means synchronization of Ukraine's grid with UCTE. The major question for Ukraine is whether to go it alone or combine its efforts with Russia and other CIS countries. While a majority of Ukrainian politicians support the country's separate interconnection, Ukraine continues working on the two fronts.

Ukrainian transmission system operator NEC Ukrenergo together with TSOs from the Baltic and CIS countries is currently part of the study group on future synchronous interconnection of the electricity transmission systems of UCTE and IPS/UPS launched in April. At the same time, Ukraine is working on its own study to identify technical, institutional and legal preconditions for separate interconnection with UCTE. The results of the above studies will be most likely available no sooner than late 2007 and will provide a solid basis for identifying the possibility and timeframe of interconnection.

In the meantime Ukraine will focus its efforts on power projects aimed at increasing electricity exports from Ukraine whilst in non-synchronous operation with UCTE as well as other "greenfield" projects. While the privatisation plans of the government remain unclear with no sales expected before 2007, opportunities exist for investors to negotiate directly with the government for the development or completion of power plant projects – the Dniester hydro pumped storage station and Dobrotvir thermal power station-2 are the most structured projects of this type – or the construction of new network infrastructure.

The government's investment strategy for the energy sector defining its preferred financing sources and payback schemes has not been announced yet and will depend on the future structure of the sector and the electricity market strategy with regard to the holding company ECU and its place in the decision making process. Hopefully, the new energy strategy, currently being prepared by the government, will provide answers to these questions as well as provide a clear road map for the development of Ukraine's power sector.

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