

# Orange revolution to speed up sector reform

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Despite the presence of many good programmes and ideas, last year did not bring many changes to the power sector reform process in Ukraine. Limited progress has been achieved in the area of the Wholesale Electricity Market (WEM) reform. The government finally established a special working commission (chaired by National Electricity Regulatory Commission) tasked with implementation of the WEM Concept approved back in 2002.

Five sub-commissions responsible for certain aspects of the WEM reform are working on elaboration of the documents needed for introduction of a full scale competitive market with bilateral contracting and balancing markets. The process is moving forward slowly, mainly due to the fact that it is fully controlled by the state agencies or state owned energy companies which are not interested in a fast transition to a new liberalized market model.

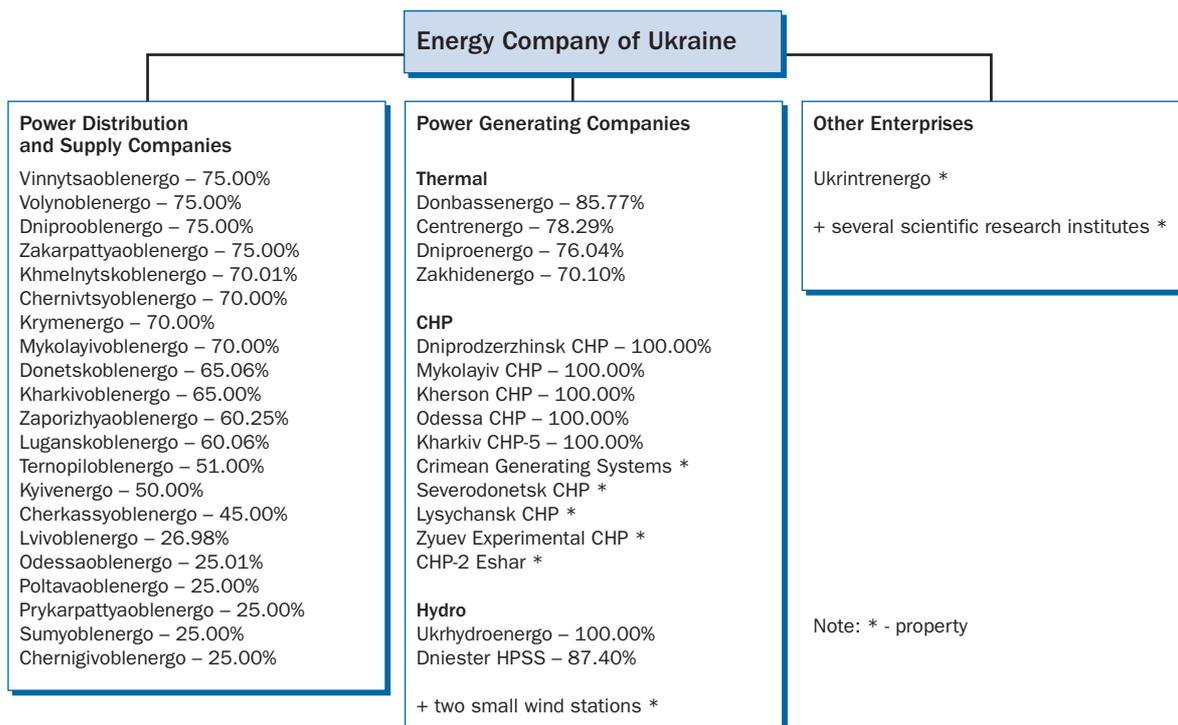
Power sector privatization has, meanwhile, been stalled since the sale of six power distribution companies (Oblenergos) in April 2001. Moreover, the government took a step back from the privatization path by creating the state holding company "Energy Company of Ukraine" (hereinafter "ECU") in June 2004 following a respective presidential decree.

The government contributed state owned equity stakes (varying from 25% to 100%) in joint stock power distribution and generating companies, previously managed by the Ministry of Fuel and Energy (MFE), to the ECU's statutory fund which amounts to almost \$1.8 billion. ECU has also received operational control over the assets of several CHP plants existing in the form of state enterprises and Ukrinterenergo, the state enterprise dealing with exports to Moldova and Eastern Europe.

The formation of ECU does not necessarily mean the end of privatization plans as the Cabinet of Ministers has a right to exclude certain equity stakes of power companies from ECU's statutory fund and transfer them back to the State Property Fund for further tender sale. However, the creation of ECU has added one more barrier as the management of the newly created holding company will naturally oppose any divestiture plans.

It is still not clear how the creation of ECU is going to affect operations of the WEM, but most likely the impact will be negative in terms of competitiveness and transparency as ECU currently unites four out of five

## Structure of the National Holding Company "Energy Company of Ukraine"



Source: IMEPOWER

large thermal power generating companies (working in the competitive segment of the market), all the country's hydro power plants and a majority of the oblenegos. Controlling 40% of the country's power generation output and 65% of power supply, ECU plays a dominant role in the WEM and equally as important has four out of ten seats on the WEM Board.

The idea of creating a holding company in the power sector was most likely inspired by the efficient operation of a similar holding company operating for many years in Ukraine's gas sector – Naftogaz of Ukraine.

Last year was the most successful yet for Naftogaz. The company completed a \$1.4 billion debt repayment transaction with Russia's Gazprom setting off old debt against future gas transit payments, received an international credit rating B+ from Fitch and raised \$500 million by issuing five-year Eurobonds with 8.125% yield. This money will be spent on expanding domestic gas and oil production, rehabilitation of the country's gas transport system, as well as development of gas and oil fields in Libya.

The coal sector could not avoid a similar trend towards consolidation. The holding company "Coal of Ukraine" was created in the autumn of 2004 on the basis of all state owned assets in the sector and despite the successful privatization of 92.11% of Pavlogradugol, one of the largest Ukrainian coal companies, comprising ten coal mines and two coal enrichment plants, in the beginning of 2004 followed by the sale of a 60% stake in another coal producer Krasnodonugol in November 2004.

Coal and gas markets remain highly centralized as the government still controls the majority of assets in these sectors and a competitive market is practically absent there. Besides, the majority of coal mines are not competitive and very much dependent on state support. Therefore, reform of the coal sector and its transition to self sustainable operations will remain one of the major challenges for Ukraine in 2005.

Transfer of the enterprise management functions over power distribution and generating companies and coal enterprises from the Ministry of Fuel and Energy (MFE) to respective holding companies left the ministry with operational control over only two strategic enterprises – national nuclear power generating company Energoatom and high voltage transmission system operator NEC Ukrenergo.

This will enable the MFE to concentrate on its major function – development and implementation of the energy sector strategy as well as ensuring stability of the power system's operations. The ministry will also continue to manage a special state budget fund financed by a special electricity tariff mark-up, functioning basically as a tax on all electricity sales via the WEM. Money from this fund is directed for strategic projects in

the energy sector, especially for construction or rehabilitation of hydro and nuclear generating capacity and high voltage transmission networks.

Significant efforts by the MFE and Energoatom in completing the most ambitious Ukrainian power project known as K2/R4 resulted in the commissioning in the second half of 2004 of two 1,000MW reactors at the Rivne and Khmelnytskyi nuclear power plants. Addition of new nuclear capacity has further increased the growing output of Energoatom that currently amounts to more than 50% of the total power generation in Ukraine.

These new units have further complicated Ukraine's energy system regulation problem. To resolve this higher priority is being given to the construction of regulating capacity such as completion of construction of the Dniester hydro pumped storage station (seven power units with 350MW capacity in generating mode and 410MW in pumping mode).

Looking for new markets for its electricity, Energoatom concluded an export contract with Russian company Inter RAO UES in November 2004. Electricity supplies started in December. The volume of export planned for 2005 is 6TWh. Ukraine also continues analysis of possible integration to the European power networks. In particular, the study of interconnection between the energy system of CIS countries and UCTE will be performed over the next two years.

The results of the recent presidential elections, which saw Victor Yushchenko defeat Prime Minister Viktor Yanukovich in a re-run of the runoff on December 26, will most likely have a positive impact on the speed of reforms in the energy sector of Ukraine. Hopefully, the new government will attract much needed private investment to the country's power sector and will give a new impulse to reform of the Wholesale Electricity Market in 2005. The role of independent regulator NERC will be crucial in the market reform process with the MFE gradually losing its influence.

The future of ECU is not clear at the moment. Privatization of power distribution and generating companies will most likely not happen as the barriers impeding attraction of private investors have not been removed yet and pre-privatization preparation of the companies (with resolution of debt problems being still the major obstacle) will take at least six to nine months. Expansion of electricity export and integration to UCTE power system will remain one of the major strategic directions for Ukraine in the near future.

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