Ukraine's own way

Yuri Kubrushko, IMEPOWER Consulting

Last year did not justify the hopes for continued reforms and privatization in Ukraine's energy sector. Moreover, Ukraine took a further step back to a centralized decision-making process in the sector. The holding company, Energy Company of Ukraine (ECU), seemingly modelling itself on Russia's RAO UES as it was prior to restructuring, strengthened its influence over the operations of all state owned electricity distribution and generating companies.

Currently, ECU directly controls 40% of the country's power generation and 65% of its power supply as well as influences the decisions of the Wholesale Electricity Market (WEM) board through the majority of votes therein.

At the end of last year, the Cabinet of Ministers transferred the powers for managing ECU and another state holding company – gas monopolist Naftogas – to the Ministry of Fuel and Energy (MFE). Previously, these companies reported directly to the Cabinet of Ministers that allowed keeping a certain balance of interests in the energy sector. The MFE also initiated the creation of the Ministry of Coal Industry to separate all challenges associated with management of coal enterprises into a separate state agency. After these changes, the MFE now remains in charge of the electricity, nuclear and gas sectors.

The newly created Ministry of Coal Industry expressed several times the idea of privatizing state owned coal mines and initiated the drafting of the respective legislation. The timing, form and conditions of such privatizations remain, at present, unclear as well as the overall strategy for the development of the coal sector, which has become an important cornerstone in Ukraine's attempts to achieve energy independence, not least in the light of the recent dispute with Russia over gas supply.

Restructuring aside, further progress has been made in improving the sector's financial situation. The level of settlements for electricity purchased at the WEM reached almost 99% in 2005. In June, parliament approved the Law "On Arrangements Aimed at Stable Operation of Enterprises in the Fuel and Energy Sector" (also known as the Debt Law) providing the framework for a comprehensive resolution of the debts of power, coal, gas and district heating companies.

A Special Settlement Centre has been created by the wholesale market operator Energorynok to facilitate and support the debt settlement process. Major mechanisms envisaged by the Debt Law include write-offs, offsets, partial repayment, restructuring and refinancing of debts. The law also provides various incentives for energy companies to participate in settlements, including certain tax privileges and a temporary ban on bankruptcy proceedings. The potential to obtain refinancing from the special tariff surcharge is an additional incentive for all market participants to restructure their debts. It is expected that the majority of settlements will be completed in 2006 once the necessary documents and procedures are approved by the government.

Tariff and pricing changes

Last summer, the Cabinet of Ministers approved a controversial decision on the introduction of a single (unified) retail electricity tariff for commercial and industrial customers. Before, the "cost plus" tariff setting methodology provided different retail tariffs for each regional power distribution company (so called oblenergo) depending on the distribution and supply tariffs set by the regulator.

The new tariff system keeps the principles of the existing "cost plus" method, but creates an additional cross subsidy mechanism between the customers of oblenergos to ensure that customers of each voltage class pay the same unified price regardless of their region. In practice, consumers in the highly industrialized eastern regions of Ukraine (who paid less for electricity in the past) will subsidize consumers in the western regions.

Surprisingly this decision, which runs counter to the declared market reform and liberalization plan, did not raise concerns on the part of the regulator – the National Electricity Regulatory Commission (NERC) – which supported the government's decision. Currently, all oblenergos are moving gradually to implement the new single tariffs since NERC has established a 5% cap on monthly increases of distribution and supply tariffs to avoid sharp hikes in retail tariffs.

While the new system does not affect directly the revenues of oblenergos from electricity distribution and supply activities, it clearly brings additional distortions to an already complicated WEM pricing system. Many experts believe that the new system will be abandoned in 2006 after parliamentary elections. Moreover, there is hope that NERC will soon start work on a new incentive-based tariff methodology and move away from the current system that does not send the right signals for cost reduction and efficiency improvements by the oblenergos.

There have also been changes in the pricing for thermal generators over the course of 2005. Most of these changes have been lobbied by the ECU. Basically, the changes were aimed at strengthening administrative control over bidding procedures for the thermal generators, which may potentially lead to setting fixed tariffs instead of the existing price bidding within a single buyer pool system and merit order dispatch. Fixed tariffs for thermal gencos have not yet been introduced as such; however, changes in price bids procedures result in no incentives for thermal generators to cut costs. Such changes in turn were one of the factors for an increase in the wholesale electricity market price. Another factor was gradually increasing fuel costs.

The growing wholesale electricity market price has finally pushed the government to review the retail prices for residential consumers, which were fixed for many years and subsidized by other groups of consumers. A clear signal was given that these tariffs will gradually increase in 2006, by at least 20%, to cost recovery levels in the next few years.

Limited opps for investors

The government has stated clearly on several occasions that privatization of electricity distribution and generating companies is not on the agenda in the near future. This could be explained by purely political factors such as its desire to keep major strategic assets in state hands and out of foreign hands.

Another factor was the need to increase the efficiency and stability of operations of the state owned energy companies and improve the financial situation of market players, prior to any future privatization.

The only opportunity, at present, for interested investors to buy into Ukraine's electricity distribution companies is to make offers to current oblenergo owners. While AES Corporation, which owns two oblenergos, seems to be doing well and remains confident in the country, the country's other big foreign investor, VS Energy International, owner of majority stakes in five Oblenergos, has reportedly been in discussions with investors, including AES, about the potential sale of its shareholdings.

As of now, the deal has not been closed and may not happen at all as VS Energy has officially denied its intentions to sell its shares. Meanwhile, various local investors are in a heated battle for control of another group of privately-owned oblenergos, and while this continues the assets can hardly be considered as an attractive investment opportunity.

With neither the Ministry of Fuel and Energy nor the ECU prepared to transfer ownership or at least control over strategic assets to private investors, their efforts have been concentrated on negotiations with international financial institutions such as the World Bank and EBRD to secure sovereign guaranteed loans for the rehabilitation of existing and construction of new electricity generating and transmission capacity.

The major achievements were the signing of a $106 million loan agreement with the World Bank for the second stage of the rehabilitation of hydropower stations (ratified by the parliament in December 2005) and a €25.8 million loan agreement with the EBRD for construction of the high voltage line in Odessa region.

The MFE is currently in the process of negotiating another loan with the World Bank for the construction of the Dniester hydro pumped storage station, which is considered the top priority project for Ukraine due to its shortage of peaking capacity.

Ukraine has, however, a sizeable surplus of supply – notably since the commissioning of its two most recent nuclear units, K2/R4, in late 2004 – and has been actively searching for export markets for this supply. The results have been mixed.

The arrival of new management at the Ministry of Fuel and Energy and ECU resulted in the cancellation last May of an export contract between Energoatom, Ukraine's nuclear power plant operator, and Inter RAO UES.

However since the beginning of this year, Ukraine has started exporting power to Belarus and is currently reviewing the conditions of electricity export to Hungary. Further export deals have been hindered by an ongoing conflict between the Ministry of Fuel and Energy and the management of Ukrinterenergo, the state company responsible for electricity exports to UCTE countries and Moldova.

Unable to remove Ukrinterenergo's director from his post by legal means, the ministry announced the idea of creating a second state owned export operator that would take over certain of Ukrinterenergo's export contracts. However, no concrete steps to this effect have so far been made.

The recent gas crisis with Russia has underlined the issue of Ukraine's energy independence and above all the need for energy efficiency. Having the most energy intensive industry in the whole of Europe, Ukraine clearly has significant potential to become more energy efficient by introducing modern energy saving technologies to reduce consumption of all types of energy resources.

It will require time, money and a coordinated approach from the government to ensure the formulation of a clear national energy strategy over the coming year to provide a solid foundation for change and reform.

Yuri Kubrushko
General director
IMEPOWER Consulting
Tel/Fax: +38 044 289 56 32
Email: yuri.kubrushko@imepower.com