Economic crisis: salvation or more suffering?

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The current economic crisis, which has hit Ukraine hard, has brought some unexpected relief for the country's power sector. Ukraine, which has over the last two years suffered from a deficit of steam coal, and this autumn had even to start, for the first time ever, electricity imports from Russia to allow it time to replenish coal stocks for this winter, is currently facing overproduction at domestic coal mines. This is a direct result of the massive fall in electricity consumption that sunk by 16% last November, reflecting slowing production in the country's major energy intensive industries.

The economic slowdown may actually help Ukraine to avoid a shortfall in generating capacity. Many industry experts had predicted demand would outstrip supply as early as 2015, leaving little time for the sector to carry out the necessary rehabilitation of existing plant or the construction of new capacity. Now, this moment will be most likely delayed by three-four years giving Ukraine valuable time to attract financing and finally start modernizing its aging capacity and invest in new generation projects.

The problem is that Ukraine, which remains a risky place for investors, will find it hard to attract capital for power sector projects these days in view of the global state of capital markets as well as the risks resulting from an imperfect domestic market and regulatory system. Privatization of the thermal power producers, which was due to start in 2008, may receive renewed support from the country's decision makers that will finally allow the launch of the sale of 60% stakes in the four generators comprising 11 power plants with installed capacity of 23 GW (though operational capacity of less than 18 GW).

Without privatization, funding from international financial institutions remains the likeliest major source of capital for the country's state-controlled power companies. Funding was previously focused on the financing of hydro, nuclear and high voltage transmission; now the attention is shifting towards thermal generation, cogeneration and renewable energy. All these projects also have the potential to receive additional revenue streams from using Kyoto Protocol mechanisms.

Reform of the wholesale electricity market, which will eventually see an over-the-counter bilateral market replace the current 'single buyer' model, supplemented by capacity auctions, a balancing market and system ancillary services market, is moving forward slowly. The target of completing the transition by 2014 seems to be over optimistic considering that the new market, as well as transition arrangements, are still at the design phase. However, first direct contracts could be concluded already in 2010.

Approval of the Green Tariff Law in October 2008 opens up good prospects for renewable energy development. The 'green' tariff will be roughly double the tariff of thermal power generators, and will be guaranteed for a period of 10 years with its rate reviewed each year based on the previous year's prices (for example, it should be about $100-120/MWh in 2010 based on 2009 tariffs of thermal generators). In addition, the wholesale electricity market is required to offtake all electricity produced by renewable energy producers.

The recent sharp drop in domestic consumption leaves the country with significant surplus supply available for export. Technical constraints and non-synchronous operations of the Ukrainian power system and the UCTE remain the major obstacle to its westwards delivery. Despite having agreed Ukraine's path towards integration with the UCTE, this whole process seems to be too lengthy. According to various experts' estimates, it will take eight to twelve years to complete full synchronization with the UCTE. Construction of back-to-back stations could be a good interim solution. Projects aimed at increasing power exports from Ukraine are particularly attractive to investors right now considering that the Ukrainian currency has fallen more than 50% against the Euro over the last few months, creating a significant gap between electricity prices in Ukraine and neighbouring Eastern Europe.

The situation with fuel markets remains complicated. Gas battles with Russia over transits to Europe and supplies to Ukraine dominate the attention of key state officials leaving no time for liberalization of the domestic gas market and creating the conditions for investment by private developers, which would allow Ukraine to substantially increase production of domestic gas resources.

Privatization of steam coal mines may also be launched this year though doubts remain mainly due to the presence of numerous barriers to their profitable operation that will discourage major investors from taking part. The sale of thermal generators requires coal sector reform and its transfer to a normal commercial footing in order to provide at least some security for future genco owners that they will be able to procure coal at fair prices.

The key precondition for implementing reforms and starting privatization is predictable decision making. However, Ukraine continues to shoot itself in the foot with its never-ending political infighting. The ability to achieve political stability in 2009 will be critical to Ukraine moving forward with its announced plans and reforms.

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