Ukraine's thermal power producers for sale

Foreign strategic investors will have their first serious opportunity to enter Ukraine's power sector following the government's surprise announcement March 21 that it would offer for sale this year 60% + 1 shares in its four thermal power producers, including the country's largest electricity producer, Dniproenergo. Further details have not been divulged with the government simply announcing that it has decided to transfer the corresponding shares in Centrenergo, Dniproenergo, Donbasenergo and Zakhidenergo to the State Property Fund, which would be responsible for drawing up the conditions of the tenders and setting starting prices. Privatization terms will, however, almost certainly require a commitment to significant investment into rehabilitation and modernization of the generators' aging power plants, which largely date from Soviet times.

The privatization is likely to attract bids from Europe's major power producers such as CEZ, EDF, Enel, E.ON and RWE, as well as AES of the US, which already has controlling stakes in two regional electricity distributors, and DTEK, the energy arm of Rinat Akhmetov's industrial holding, System Capital Management, which is the largest minority shareholder of Dniproenergo, as well as the owner of the country's major privately owned thermal power producer, Vostokenergo. Last month, Maksym Tymchenko, the head of DTEK, said that the group would be interested in participating in any power sector privatizations.

Kiev's decision to proceed with the privatization of the thermal power producers this year comes as a surprise for a number of reasons. Firstly the current administration, led by Prime Minister Yulia Tymoshenko, like that of its predecessors, seemed intent on retaining state control of key strategic assets, with the expectation that control would ultimately be handed to local business interests.

Secondly, Ukraine is in the early stages of reform of its wholesale electricity market. Instead of the current single buyer model, where Energorynok buys all electricity, averages the price and sells it to suppliers at a blended price, the new market structure will comprise bilateral contracts as well as a balancing market. In November 2007 the government ordered the National Energy Regulating Commission and the Fuel and Energy Ministry to liberalize the domestic energy market by introducing direct contracts between suppliers and consumers of electricity before 2015. The new market model will enable large consumers to sign contracts directly with producers, bypassing the wholesale market operator, Energorynok. The government has targeted 2009 as the first year when companies will be able to sign such contracts, though on a very limited scale (5% of total volume).

For the government there are two main drivers for privatization of the gencos. The sale of majority stakes could raise in excess of $5 billion for the state budget at a time when the value of the gencos' is at a record high and investor interest is strong. According to Kiev-based investment bank, Dragon Capital, the current values of 60% + 1 stakes in Centrenergo, Donbasenergo and Zakhidenergo, are $1,496 million, $647 million and $1,201 million, respectively, while a 50% stake in Dniproenergo, on the assumption that the state cannot overturn last year's share capital increase, is worth $1,854 million.

Secondly, rapid consumption growth and domestic fuel shortages, which led to a halt in electricity exports to Russia and Belarus, last year, have forced the government to put the long-shelved issues of sector privatization and market liberalization back on its agenda.

Investment is urgently required in the country's aging thermal power plants if Ukraine is not to face supply shortages, and the government has accepted that a sale to private investors is the only way the state can attract the necessary investment required to deliver increased and improved electricity production. With domestic nuclear power plants already operating at a high utilization rate of 76%, and with electricity consumption in Ukraine expected to grow at close to 4% per annum on average over the next decade, the four thermal power generators will be required expected to cover most of the additional energy demand. Analysts expect the gencos' output to increase on average by 6.7% per annum, led by Dniproenergo and Centrenergo, thanks to their more modern plant and higher growth potential.

Sector players as well as the government recognize that privatization is the only viable way forward but equally acknowledge in light of ongoing market reform that the need for a clear regulatory and operating environment for the generators is imperative for a successful privatization for both investors and Ukraine. Only by achieving this will the sale attract the right quality of investors and allow the government to maximize privatization revenues.

"Nobody doubts that it is the right path but the main challenge is to ensure that the process is not rushed and structured properly," Yuri Kubrushko, general director of Kiev-based Imepower Consultants, told Platts, March 24. The 'devil is always in the detail', he added.

"Given that thermal generators will be significantly affected by market reform plans, investors will need a clear outline and schedule of the transition to a new market model before the privatization, so that they can properly plan and understand in which regulatory framework and market environment they will be operating over the next five-seven years," he said. Meanwhile, it is in the interests of the government and the generators that a proper monitoring system be put in place to make sure that the sale attracts the right level of investments and that they are used for their intended purpose."

"The value of the generating companies will be higher if the government develops clear privatization conditions that would provide some clarity and guarantees for the potential buyers in terms of potential market structure, pricing, debt resolution and other key issues, so investors can calculate returns on investment," he said. In addition, while the stakes on offer will be large enough to attract strategic investors and give them management control, the value of these stakes would be increased if investors are given the option of increasing their equity stakes in the future up to 75%+1 share, where possible, said Kubrushko. Dennis Sakva, utilities analyst at Dragon Capital, believes that the state could offer buyers an option to buy its remaining post-privatization shares – 18.3% in Centrenergo, 15.77% in Donbasenergo and 10.1% in Zakhidenergo – on condition that they meet their investment obligations in full.

The government's privatization announcement would seem to assume that it is confident it can overturn last year's share capital increase at Dniproenergo that gave DTEK a 44% stake in the company, effectively diluting the state's stake from 76% to 50% plus one share. This would seem complicated at present given the ongoing legal dispute between its majority owner, the state holding company, Energy Company of Ukraine, and its major minority shareholder, DTEK.

Last year, under the previous government of Viktor Yanukovich, with whom Akhmetov has close ties, Dniproenergo's shareholders voted to increase its share capital in favour of DTEK, for payment of outstanding debts (*EiEE 125/25*). However, since the return to power last September of Tymoshenko, who in opposition criticised the deal, a regional court annulled it, a decision the country's highest financial court is now reviewing. Most recently, ECU held March 21 an AGM, at which it appointed a new supervisory board, including ECU chairman Volodymyr Zinevych. Dniproenergo refused to comply, stating the AGM was illegal, which was confirmed by the State Securities and Stock Market Commission. Sakva said that the news was "troublesome as the current confrontation may lead to a long-lasting conflict".

As a result, analysts do not expect privatization of the gencos to happen this year and that only three of the four will interest reputable foreign strategic investors given the fact that the battle for control of Dniproenergo may run for awhile. "The government will not do the sale this year due to the lack of a strategic plan for privatization and [the need for] further sector development both for coal mines and generators," said Yuriy Oleksiyenko, an analyst at KBC Securities. "Moreover, the government needs to prove its rights on the 60%+1 stake in Dniproenergo. We think that the resolution is just the starting point for cancellation of Dniproenergo's additional share issue and further privatization".

Dniproenergo

The country's largest thermal power generating company, owns and operates three power plants in the heavily industrialized regions of Zaporizhya and Dnipropetrovsk with a total installed capacity of 8,160 MW, which accounts for 15.6% of domestic generating capacity. Commissioned predominantly in the 1950s and 1960s, the company's power plants – Kryvorizhska, Prydniprovska and Zaporizhska – are relatively efficient due to their ability to fire on both gas and coal. Coal accounted for 87% of its fuel input in 2006, with gas and oil making up 11.6% and 1.4%, respectively. Last year it posted a 1,108% rise in net income to $24.1 million, and a 41% rise in EBITDA to $79.6 million on net sales of $758 million, up 38% year-on-year due to a 12% increase in the volume of electricity sold (15,278 GWh) and a 23% increase in its tariffs from $0.0396/kWh to $0.0486/kWh.

Centrenergo

Ukraine's second largest state thermal power producer, in terms of output and in terms of installed capacity (7,575 MW) accounting for roughly 15% of the Ukrainian electricity generation market. The company owns three large power plants in industrialized regions of the country: Vuglegirska (3,600 MW) in the Donetsk Region, Zmyivska (2,175 MW) in the Kharkiv Region and Trypilska (1,800 MW) near Kiev. Most of the company's 23 power units use coal, which accounted for more than 80% of its total fuel input in 2006, while three units can run on natural gas (or 19% of total fuel input in 2006) or fuel oil. In 2006, Vuglegirska's seven units produced 30% of its total electricity output, Trypilska's six units produced 28%, and Zmyivska's ten units produced 42%. The company reported a 28% year-on-year fall in its net profit for 2007 to $12.6 million, despite a 29% rise in net sales to $679 million, due largely to tariff growth failing to offset a larger increase in coal and gas prices.

Zakhidenergo

Ukraine's third-largest thermal power producer in terms of installed capacity (4,708 MW and 9% market share) and in terms of output. Zakhidenergo operates three plants – Burshtynskaya, Dobrotvirskaya and Ladyzhinska – which as well as producing for the domestic wholesale market also export to Central and Western European markets. Burshtynskaya is the only plant in Ukraine linked to the European power system, UCTE. Dobrotvirskaya, meanwhile, exports 100 MW of its 300-MW capacity to Poland. The western Ukrainian thermal power producer posted a 122% increase in net income for 2007 to $9.9 million, on the back of a 16% rise in net sales, which totalled $715.8 million. The genco's electricity sales to Energorynok, the wholesale market operator, fell 2% to 13,748 GWh, but were offset by a 19% increase in its electricity tariff.

Donbassenergo

Ukraine's smallest thermal power producer, operates two thermal power plants – Starobeshevskaya and Slavyanskaya – with total installed capacity of 2,630 MW, accounting for 5% of domestic generating capacity. In 2006, coal accounted for 90% of total fuel inputs, and gas 9.5% of total fuel inputs. Donbassenergo lost 54% of its capacity in 2001 when three of its five plants were surrendered to a private company, as a result of a debt restructuring process. The company posted net income of $5.3 million for 2007. Despite lower production and sales by volume, which fell 8% to 6.1 TWh, net sales rose by 7% year-on-year to $291 million due to a 16% rise in its average tariff from $0.0405/kWh to $0.0476/kWh.