

# ICPS newsletter

## Reform in the energy sector: destruction or improvement?

***In order to increase the competitiveness of its national economy, the Ukrainian government is concentrating on structural changes in key sectors of the economy. The major goal of reform in the energy sector should be to ensure the functioning of a transparent, competitive, and effective electrical energy industry. It requires the improvement of the current structure of the energy market, rather than designing a new one. This idea was addressed by participants of a public discussion on "Reform Policy in the Energy Sector", which was held as a part of ICPS's "Ukraine's Future: Public Feedback on Reform Policy" project***

**What are the ways to harmonise different interests in the energy sector?**

The fuel and energy complex is the basis for economic growth, as social and political stability of a country depend on its

capacities. That is why reforms in the fuel and energy complex concern the whole society. For example, citizens and enterprises expect stable electricity supply and unlimited consumption; at the same time, power generating and distributing companies demand the proper

implementation of contract commitments, stable tax policy, and increased collection levels of cash payments.

To date, energy policy has entirely reflected the interests of one group only—the winner in this particular political fight. However, no group's interests have coincided with the national goal of stable, long-term development of the energy sector, nor have they provided for sector capitalisation and investment in its growth. Today's policy has resulted in a deep electricity crisis, and in order to overcome this crisis it is necessary to harmonise legal private and group interests with the national one. The national policy should determine and guarantee the unilateral development of the energy sector.

According to Mr. Oleksii Kucherenko, first deputy head of the Verkhovna Rada Committee on the Fuel and Energy Complex, all these different interests could be balanced and united around the following mandate: to ensure the steady performance of the fuel and energy complex through the introduction of a transparent and clear structure of the energy market.

Drafting and analysis of economic justifications for each proposed option for the energy market structure are an important step forward in determining a coherent model. On the basis of the main indicators characterising energy sector capacities, the authors of this conception should assess what effect the proposed innovations will have. Mr. Kucherenko believes that the analysis will make it possible to find a single alternative for the energy market structure which would be accepted by all stakeholders.

### Energy crisis not caused by the chosen model

Ukraine adopted the English pool—the system of energy sector regulation featuring (i) vertical integration of energy production, transportation, and sales; (ii) monopolised wholesale marketing, i.e.,

### ***There is no need to destroy market structure***

*Zinovi BUTSIO, advisor to the prime minister of Ukraine: "The current government is fully confident that there is no need to destroy the structure of the wholesale energy market as adopted in the Law of Ukraine 'On electricity'—there is only the need for its improvement. To ensure the energy market's proper functioning, a Board for the energy market should be legally adopted, the clearing account issue should be settled, and the multilateral Wholesale Energy Market Agreement must be legitimised. The government is sure that this market structure would be able to function if fundamental changes are made in market agent obligations."*

### ***If you don't pay, you don't get any more***

*Bill FRANKS, economist at the European Bank for Reconstruction and Development: "Focus should be not on finding a new system, but on improving the existing system of the energy market. Today, the main problem is non-payments at the user level. The approach to solve this problem should be that if you are not able to pay for supplied electricity, you do not get any more."*

### ***Imperfect legislation is the main problem***

*Svitlana HOLIKOVA, director of the TransErgoConsulting company: "Developed countries have dozens of laws regulating the energy sector. In Ukraine only the one Law 'On electricity' was adopted—it does not cover the majority of aspects and does not explain the energy market principles. Moreover, the wholesale energy market agreement was not legitimised. The first task of the government should be to design clear, logical legislation for energy market development. Today, we cannot show investors on paper what regulations we have for the energy market. The second stage should be oriented to developing effective inner regulation of the market on the basis of existing documents. Laws on the competencies of government bodies in the energy sector and on state regulation of the sector should be adopted."*

### ***The government is not able to control the energy sector***

*Oleksii SHEBERSTOV, general director of the Energy Consulting Group: "The existing situation in the energy sector was caused by faulty reforms. Besides, the government continually interferes in our operations, while it appears to have no capacity to do it. Only effective owners will be able to change the situation for the better."*

mandatory sales of all produced electricity to the pool, which plays the role of the wholesale energy market; and (iii) direct electricity sales from the pool to regional traders or separate large consumers.

However, today in Ukraine this model is functioning poorly. Ms Petra Opitz, an expert with the German Advisory Group on Economic Reform to the Ukrainian Government, believes that energy sector problems are caused not by the chosen system of regulation, but by the failure to meet the main requirements for system functioning. To solve this problem, the current system should be improved, rather than a new one designed. Ms. Opitz proposed to implement the following measures in order to overcome the energy crisis:

- separate the accumulated debts of consumers and current commitments;
- stop electricity supply to all consumers-debtors. The government must meet its commitments regarding those groups of consumers which are funded by the state or local budgets. In budgets it is necessary to plan funds for paying electricity consumption; moreover, these funds should be allocated directly to budget-sponsored institutions;
- introduce sanctions against any breach of contracts by energy market agents;
- conclude direct-sale agreements between the energy market and energy producers, and also between the market and energy suppliers or electricity buyers concerning the volume of electricity supply during certain periods of time, at a determined price;
- transform the Energorynok enterprise (i.e., the energy market) into an independent agent controlled by the public. According to the pool model, wholesale traders are monopolists which should be regulated;
- determine clear and transparent "rules of the game" before beginning privatisation.

### Attracting international investors is the main objective of privatisation

In 2001, the government of Ukraine intends to complete privatisation of the energy sector. In particular, in 2000–2001 it is planned to sell all energy supplying companies and in 2001 to begin privatisation of thermal power plants. Mr Oleksandr Bazarov, president of the Credit

## Summarised public proposals developed during group work on reform policy in the energy sector

Stakeholders in the energy sector:	Social (national, strategic) interests of Ukraine in the energy sector:
<ul style="list-style-type: none"> <li>• state-owned enterprises and private consumers are interested in access to electricity at minimal prices;</li> <li>• international investors are interested in a stable environment for long-term investment ensuring profits;</li> <li>• political parties and politicians are interested in the sector as a tool in their political fight;</li> <li>• public officials are interested in the possibilities of making decisions, and guaranteeing jobs;</li> <li>• oligarchs;</li> <li>• the whole nation;</li> <li>• fuel suppliers are interested in solvent demand.</li> </ul>	<ul style="list-style-type: none"> <li>• stable development of a single power system;</li> <li>• investment in sector development;</li> <li>• uninterrupted electricity supply to solvent customers;</li> <li>• social stability;</li> <li>• independence of the energy system from external factors;</li> <li>• guarantee of energy saving;</li> <li>• balancing the interests of all players in the energy sector.</li> </ul>
Strategies to reform the energy sector:	Assessment of government actions in reforming the energy sector:
<ul style="list-style-type: none"> <li>• improve the current structure of the energy market, i.e., combine business initiative, social interests, and market regulation, developing on this basis and legitimising a strategic action plan with mandatory introduction of energy-efficient technology and the comprehensive transformation of the economic legal framework;</li> <li>• strengthen administrative control and ad hoc decision making;</li> <li>• introduce direct agreements under current conditions.</li> </ul>	<ul style="list-style-type: none"> <li>• the government has not determined a strategy responding to national interests and is continuously under pressure of certain group interests;</li> <li>• government actions meet only short-term objectives;</li> <li>• they could result in a destroyed energy system in 2000;</li> <li>• they do not meet competition requirements.</li> </ul>

Suisse First Boston (Ukraine) joint-stock bank\*, noted that according to the bank's agenda, the sale of seven regional energy-distributing companies would be completed by the end of 2000.

As it was declared in the Cabinet of Ministers Action Plan, the privatisation of energy-distributing companies will be oriented at attracting strategic investors—international power companies. Sales terms will be agreed with all candidates before starting the tender. Mr. Bazarov emphasised that tender sales would be held without any investment commitments, and the only and key criterion for determining tender winners would be their proposed price. Transparency and publicity will be the absolute principle in the privatisation of energy-distributing companies.

Mr. Bazarov believes that in order to succeed in the new stage of privatisation and avoid old mistakes, the following factors need to be ensured:

- political will and personal control of privatisation of energy-distributing companies on the part of senior public officials;
- existence of a long-term development strategy for the energy sector;
- stable and transparent "rules of the game" in the energy market;
- personal participation of senior public officials in negotiations with potential investors;
- co-ordinated assistance of international donors. ■

*A public discussion on "Reform Policy in the Energy Sector", co-organised by the Secretariat of the Cabinet of Ministers and the Ministry of Economy of Ukraine, and the International Centre for Policy Studies with the financial support of Freedom House, was held at ICPS on June 9, 2000.*

\* Credit Suisse First Boston is an advisor to the State Property Fund of Ukraine on the sales of first tranche of seven companies.