# Reform or die

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When things start going right in Ukraine, they soon go wrong. No sooner had US-based power multinational AES bought into distribution, put investment capital on the table and signalled interest in generation, than the country's biggest thermal generator lost its three principal power stations in a bizarre judicial asset grab.

AES's $68.9 million purchase on 17 April of 75% stakes in two regional electricity distributors (oblenergos), Kyivoblenergo and Rivneoblenergo, really was good news for Ukraine's troubled energy sector. AES is to invest a further $90 million in the two companies, and hopes to lead by example in tackling non-payment problems. Controlling stakes in a further four regional distributors ? Khersonoblenergo, Kirovohradoblenergo, Sevastopolenergo and Zhytomyroblenergo ? were bought by Vykhodoslovenske Energeticke Zavody (VEZ) of Slovakia on 24 April for $90 million. The sale of these six regional distributors, out of a total of 27, comprised the first successful, transparent power privatisation. CSFB managed the deal for the State Property Fund, and hopes were raised in a sector usually identified with corruption on a grand scale.

Those hopes were soon deflated. On 28 April, when the Kurahovska, Luhanska and Zuevska thermal power stations ? three of the five owned by Ukraine's largest thermal generator, Donbassenergo ? were sold off to an undisclosed buyer for a paltry 160 million hryvna ($30 million) by the state executor, Ukrspetsyust. The sale was initiated under an obscure debt recovery law to recover Donbassenergo's debts to Energetika i Palyvo Ukrainy, a subsidiary of the state oil and gas monopoly Naftogaz Ukrainy. The fuel and energy ministry and the State Property Fund, which administer the state's 80% stake in Donbassenergo, were incensed, and the European Bank for Reconstruction & Development, which lent Donbassenergo $113 million to upgrade another power station, Starobeshevska, made furious protests. Not furious enough, though. On 27 June Ukraine's Supreme Court ruled that Donbassenergo's legal challenge to the sale was invalid.

The dispute is unresolved. State Property Fund director Aleksandr Bondar says the three stations were sold for less than a quarter of their real value, 700 million hryvna, and that further legal challenges will be mounted. Meanwhile president Leonid Kuchma, whose attitude to power sector corruption remains unclear, on 1 August vetoed a law passed by parliament in an attempt to block future Donbassenergo-type asset grabs, which placed an indefinite moratorium on court-ordered sales of state companies' assets and a ban to 1 June 2002 on sales of state power industry holdings.

Privatisation of distributors

AES Silk Road, the AES subsidiary covering the former USSR that cut its teeth in the tough Georgian and Kazakh markets, is determined to make things work at its new Ukrainian purchases, Kyivoblenergo and Rivneoblenergo. Mikhail Malovanyi, director of AES Silk Road's Ukraine office, says that an investment plan for Rivneoblenergo has been agreed with the fuel and energy ministry, and one for Kyivoblenergo will follow soon: over the next five years, AES will invest about $40 million and $50 million respectively in the companies.

?Firstly we will computerise and upgrade the metering of supply from Energorynok [the state-owned wholesale electricity supplier], and of our supply to customers. A high level of accuracy is vital,? said Malovanyi. ?We will also introduce new billing systems.? Traditionally 40% of Ukrainian power is lost through inefficiency and robbery in transport systems; in AES's companies it is about 20% and Malovanyi is intent on driving it down further. He added: ?We will modernise all our basic plant: transformers, switching gear and distribution equipment. In countryside areas we want to move from wooden poles to concrete ones to ensure greater reliability of supply.?

All the work will go out to international tender. Black & Veatch, who installed supply accounting systems for AES in Georgia, must be hopeful of doing some of it. Alstom will be a strong contender: it has been active in Ukraine since 1993, and has supplied switchgear, monitoring and relay protection systems and other equipment to the Dniproidroenergo hydro-generating company, switchgear to the Dnestr power station, and monitoring equipment to Ukrenergo, the state-owned national transmission company. It has worked downstream too, and in September last year was contracted to supply boilers to Kievenergo, the city power company, for the capital, which has been loaned $200 million by the World Bank to modernise and decentralise heat supply.

Can the Ukrainian authorities, together with AES and VEZ of Slovakia, succesfully reform distribution? The answer depends in large part on tariff policy issues. Before privatisation, the government issued a decree providing for disconnection of non-payers, the new owners of distribution capacity committed themselves to raising the rate of cash collection from about 70% to 100%, and to paying for electricity received from Energorynok in full. A change in tariff methodology was agreed; the scale of increases depends on the national energy regulatory commission (NERC), the state regulatory body for the industry. Malovanyi of AES says: ?Once our investment plan has been approved by the NERC, the next step will be for the commission to acknowledge the need to raise tariffs. We can show the possibilities available to develop the companies, where investment programmes have been underfunded for some years. The regulator then has to decide to raise tariffs ? not all at once, but step-by-step over a period of years.?

The issues of tariffs, and debts, will also figure prominently in the next round of privatisation, in which another 12 regional distributors go under the hammer. This time it will be tougher: whereas the first six companies had $136 million of debts between them, which the government agreed to restructure, the next 12 have total debts of more than $1400 million. Ministers are wary about agreeing to a similar restructuring. Although the State Property Fund has said it wants to dispose of the companies this year, market observers say the sale will not happen until the debt issue is resolved and the NERC completes its current tariff review.

At CSFB, which has been hired to do the second sale after its success with the first, energy sector specialist Serhiy Syvoplyas says: ?A number of issues will have to resolved before the sale. The government will have to make clear its attitude to restructuring the companies' debts, and the NERC will have to complete the tariff review. Potential bidders will also want to see clear indications that the government delivers on its promises: they will want to see that the government is prepared to implement the decree on discontinuation of supply to non-payers, to support the six privatised oblenergos in taking a tougher line on non-payment and to deliver on other promises about tariffs and tariff methodology.?

CSFB is now undertaking due diligence on the companies ? Vinnitsaoblenergo, Volynoblenergo, Zakarpattyaoblenergo, Chernivtsioblenergo, Khmelnitskoblenergo, Cherkasyoblenergo, Ternopiloblenergo, Zaporizhiaoblenergo, Dniprooblenergo, Krymenergo, Donetskoblenergo and Kharkivoblenergo ? which jointly serve more than 9.8 million customers and in 2000 distributed more than 37,800 GWh.

Generation ? vertical integration

In contrast to the World Bank and other multilateral institutions, who insist that separating generation, transmission and distribution is the formula for success, some big players seek vertical integration in emerging markets, Ukraine included. Garry Levesley, president of AES Silk Road, says: ?We certainly want generation capacity in Ukraine. We are a generation company, and we didn't own any distribution capacity until 1996, when we went to Kazakhstan and bought power stations ? and then realised the only way we were going to get paid was by getting into distribution. In Georgia we started in distribution and moved into generation.?

Ukraine's four thermal power generators ? Donbassenergo, Dniproenergo, Centrenergo and Zahidenergo, which comprise 14 thermal stations with total installed capacity of 36.6GW ? are now expected to be sold off between 2002 and 2005. Two hydro generators, Dniprohydroenergo and Dnisterhydroenergo (total installed capacity of 4.7GW), and Energoatom, which owns Ukraine's five nuclear power stations (capacity 12.8GW), are legally bound to remain state-owned.)

The absurd political and legal environment that made possible the Donbassenergo asset-strip is hardly likely to heighten investors' enthusiasm for the generators. And, incidentally, it's not only Donbassenergo at risk: since the whacky power station sale, unnamed buyers have reportedly been scooping up generating companies' debt, possibly with a view to further unorthodox acquisitions.

Nevertheless, there are compelling fundamentals that make these assets attractive. Ukraine's well-known energy shortages are due to poor maintenance, overconsumption by industry and lack of fuel. Generating capacity remains twice as great as peak demand, and there is no reason why Ukraine could not again become a major exporter of power to central and eastern Europe, as it was in Soviet times.

Indeed two export-oriented generation projects are being co-ordinated by Kyiv-based Imepower, an alliance of utilities sector financial consultants Ineko Management and EnCoG (energy consulting group), formed in 1996 by three former energy ministers.

The first project is to upgrade Dobrotvirska thermal power station in western Ukraine, near the Polish border. The station burns Polish coal from the Silesian field as well as Ukrainian coal, and exports power to Poland. The project, which involves installing three 225MW power units and upgrading existing high-voltage transmission lines, will raise export capacity to 250MW; $50 million of a total estimated cost of $120 million has been spent so far, and further investment is sought through a project company, now 99%-owned by Zakhidenergo. The second, larger, project envisages reconstruction of Burshtinska, the biggest power station in western Ukraine, which has scarcely received any investment since being commissioned in 1965, but which could be upgraded to UCTE-CENTREL standards and raise its exports to Slovakia, the Czech republic and Hungary. A $60 million first stage of reconstruction is envisaged with a payback period of four years; wholesale reconstruction would cost $1300 million. Imepower says a third project ? the completion of the Dniester hydro pumped storage station ? would help cover peak demand if Ukraine was to join the UCPTE system; a tender to manage the project was won last year by Bahamas-registered ESI Engineering & Construction, who are now negotiating with Energorynok on the terms of a power purchase agreement.

Vassili Nan'ko, deputy director of Imeko, says: ?Projects such as Burshtinska are vital to Ukraine's integration into the European energy system. Of course investors are hesitating because of political, legal and tax issues. But we will see how AES fares in distribution, and perhaps then things will move on.?

Breaking debt and corruption

In the end much will depend on whether Ukraine can break the vicious circle of debt and corrupt practices, which has pervaded the energy sector for a decade. The fall-out from the collapse of the USSR has been more devastating, and impoverishing, for Ukraine than for Russia. Little has been done to reform its outdated, power-guzzling industries and the debts have kept rising: the distribution companies owe an estimated $2.8 billion to Energorynok, which owes $2.8 million to the generators, who owe $3.5 billion for gas and other fuel ? mostly to Gazprom of Russia and gas trader Itera.

There are some good signs. Ukrainian-Russian relations have improved, much of the gas debt been converted into Ukrainian government bonds, agreement reached at least in words about how to prevent debts piling up again ? and hopes raised that Russia will stop using the debt as a political stick to beat Ukraine. The gas trading scam, under which trading companies allotted quotas by the state in 1995 were used to enrich criminals, has been exposed, and one of the chief beneficiaries, former prime minister Pavel Lazarenko, is in jail in the US. Another prominent gas trade executive of the time, Iulia Timoshenko, underwent a remarkable conversion and in a brief spell as energy minister this year instituted tougher accounting standards in the sector and enlivened a task force, comprising government and multinational institutions, to push reforms ahead.

Then there are bad things. Georgy Gongadze, a journalist who questioned Kuchma closely about his own involvement in the Lazarenko scandal, was brutally murdered, and a political crisis triggered early this year by the publication of audio tapes on which a voice that seemed to be Kuchma's urged that Gongadze be ?dealt with?. Timoshenko was sacked and spent a while in jail, apparently because she fell out with Kuchma. Reformist prime minister Viktor Yushchenko was sacked too, in April, and no-one yet knows how effective his replacement, Anatoly Kinakh, will be.

Ukrainian power is not a market for the fainthearted.

**Russian Restructuring**

When the national power company says it is short of $170 million to stockpile fuel for this winter, and some regional distributors have less than 50% of the fuel they need, you know sector reform is unpostponable. So it's a good job that after months of haggling with interested parties, the Russian government has finally adopted a power restructuring plan that clears the path for billions of dollars of badly-needed investment.

The warning of another tough winter came from UES, the Russian power monopoly, on 2 August. It said it had borrowed 1.5 billion roubles (just over $50 million) from four Russian banks, but needed another 5 billion for stockpiles and couldn't provide loan guarantees for that amount.

Collectively, on 1 August UES subsidiaries had 12% more fuel than they need, but the undersupplied regions that went cold for stretches of last winter are way behind target. Dalenergo of Vladivostok, which supplies Primorye region in the Far East, where last winter's power cuts triggered a major political crisis, had just 61% of its target coal supply. Neighbouring Kamchatskenergo had only 38.6%. In central Russia, Penzaenergo had 42.3% of its target and Vladimenergo just 33.5%.

UES said the real problem is tariff increases ... and hit the restructuring programme's sore spot. The government is worried that tariff increases will fuel price inflation. But it's a nettle that has to be grasped: while in the short term, low tariffs starve regional distributors of investment capital, in the long term they stymie western interest in power sector investment all together.

Russian tariffs are about 1.38 cents/kWh for industrial users (against roughly 6 c/kWh in the EU) and 0.78 c/kWh for residential users (against roughly 12 c/kWh). In dollar terms, these are less than half of the levels before the 1998 financial crash. Even in Ukraine tariffs are more than twice as high as Russia's, at 3 cents/kWh; in Georgia they are 3.5 cents/kWh. Some industry analysts argue that if Russian tariffs were at these levels, or slightly higher, investment would be viable.

Certainly an important precondition for raising tariffs has now been fulfilled: the epidemic of non-payment has been largely eradicated. The main claim to success by the UES management team headed by reformist former deputy prime minister Anatoly Chubais is that by the end of 2000 it was close to its target of 80% cash payment by customers, up from 19% in 1998.

Another cause for optimism is that ? after lengthy arguments, mainly between Chubais, presidential economics adviser Andrei Illiaronov and minority portfolio investors in UES, who mainly manage US funds ? prime minister Mikhail Kasyanov signed off the electricity restructuring plan on 11 July. The plan, due to be implemented by 2008, provides for:

? In generation, the creation of 5-7 large generating companies, in place of the 31 UES subsidiaries that now operate the largest hydro and thermal stations. The new generators will be wholly-owned UES subsidiaries for a transition period, and then become fully or partly independent market participants;

? A competitive wholesale market with a free pricing system based on marginal costs, to replace the existing regulated wholesale market. Tariff regulation will remain in regions where wholesale market competition is not feasible for technical reasons;

? Regional energos that will continue to own both generation and distribution assets, and, crucially, regional low-voltage transmission networks. The number of energos will be reduced from the current 74 down to less than 40;

? High-voltage transmission assets consolidated into a federal network company, to be established as a UES subsidiary but eventually to be majority state-owned;

? A systems operator to be set up by merging central and regional dispatch unit, and function as technical co-ordinator of all market transactions. A market operator to oversee settlement of wholesale market transactions.

Hartmut Jacob, power industry analyst at Renaissance Capital in Moscow, said that as a result of lobbying by minority investors, the government has given a clear commitment that shareholders in UES would receive pro-rata stakes in successor companies. Last-minute alterations to the plan that left control over low-voltage transmission lines in regional energos' hands was ?good for investors, who feared that without these lines the energos would be worth little, but bad for sector reform, because foot-dragging on efficiency improvements in the regions will persist?.