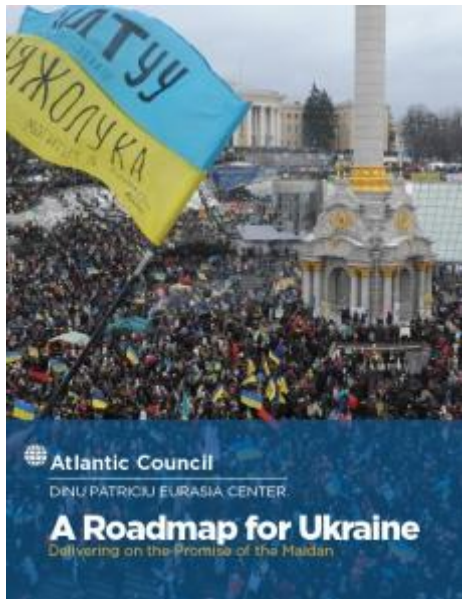


A Roadmap for new Ukrainian authorities - energy sector



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Atlantic Council Dinu Patriciu Eurasia Center has conducted in April-June 2014 a research project with involvement of international and Ukrainian experts and the aim to develop recommendations for new Ukrainian authorities.

SECURING UKRAINE'S ENERGY SECTOR

Energy represents one of Ukraine's greatest vulnerabilities and sources of potential strength, and must be central to a broader effective and comprehensive economic reform plan.

Energy is the linchpin of Ukraine's dependence on Russia. The Kremlin has used energy as a weapon not only to exert leverage over Ukraine, but to control its leaders and key power players who are personally enriched via opaque energy deals with Russia. As such, the energy sector is a critical pillar to building an effective, stable national security and economic strategy for Ukraine.

This strategy must be long-term in scope yet also one that will have an immediate positive impact. The Atlantic Council has developed this roadmap for the new administration in Kyiv to clean up, reform, and liberalize Ukraine's energy sector and integrate it with European Union's energy market.

The Challenges

Despite its energy resources, the country's economy itself is far from optimal. Successive rounds of systemic theft and mismanagement left Ukraine's government coffers chronically cash-strapped. Furthermore, external political pressure and inertia of previous governments left Ukraine with a ruinous gas contract with Russia. The country is not only in an asymmetric war, but also in an economic war with Russia, resulting in negative growth, especially in its eastern regions. Lack of transparency and the misuse of energy rents have paralyzed the political system and bolstered the country's oligarchy. It has also weakened legitimacy of the state and people's trust in the government, and its ability to stand up to Russian pressure and aggression, especially in eastern Ukraine.

In sum, Ukraine's energy situation is unsustainable, as currently 7 percent of gross domestic product (GDP) is spent on natural gas subsidies. This will only be slightly helped by the current increase of gas and utility prices, as close to half of the increase has already been consumed by the 25 percent depreciation of the hryvna against the US dollar.

The European Union (EU) has tried to foster reforms in Ukraine through different instruments and with limited success. Central to the efforts was the Energy Community Treaty, which requires member states to adopt the EU's energy acquis. The Treaty stipulates energy sector reforms and regulates third-party access to the

energy grids as well as the unbundling of transmission and generation assets. Even though the EU has tried to give concrete assistance, such as the 2009 agreement on renovating Ukraine's gas pipelines, progress on these reforms has been very slow. The International Monetary Fund (IMF) has also tried to push reform on the domestic gas market in order to eliminate the gas subsidies tanking the national budget.

Furthermore, Russia is fundamentally opposed to reform efforts establishing greater transparency. As Moscow wants to formalize its control of the gas transit system, it prefers its murky deals with Ukraine. By putting in place a new and transparent regime for the transit arrangements with Russia, the Ukrainian government can help ensure that these funds are not misused for personal gains. Going forward, Ukraine should recalibrate the balance between the maintenance of its transit status, on the one hand, and developing its own domestic resources and diversifying its outside supplies, on the other.

The new presidential administration must seize the opportunity to implement new measures to build a more independent, secure, and sustainable energy system for Ukraine.

Recommendations for the Ukrainian Government

Steps taken to reform the country's energy sector in the next one hundred days will be crucial, first and foremost to lessen Ukraine's dependence on Russia and clean up a corrupt and inefficient energy system. As a matter of urgency, the new Ukrainian leadership should undertake the following steps:

Priority 1: Transparency. Injecting transparency and eliminating rents is the sine qua non of energy sector reform in Ukraine. Furthermore, such transparency will serve to bolster the population's confidence in the government's legitimacy.

Hold an independent technical and financial audit of the energy sector. Ukraine needs to conduct an independent audit of the hydrocarbon extraction and distribution sectors. This should include a transparent public inventory of all extraction wells with disclosure of their owners and distribution networks of the resources, as well as of the ownership of distribution networks.

Conduct a governance and regulatory reform to increase transparency and efficiency. Legislation must be put in place to increase transparency, streamline regulations and the tax code, and ensure that all regulatory bodies have power and credibility. The energy regulator (NKRE) and the antitrust agencies in particular need to be fully independent and empowered in accordance with the law and international best practices with special regard to the Extractive Industry Transparency Initiative (EITI). A streamlined and simplified licensing and taxation system, and a transparent mechanism of public procurements are also a must. Equal treatment of domestic and foreign investors should be ensured by the state, enshrined in law and observed in practice.

Improve information about gas flows.

There is a need for improved information about gas flows, especially through the installment of gas metering stations at the Russian border. Ukrtransgaz needs to establish a real dispatching center, by which gas flows and information over the main lines should be controlled. This will require negotiations with Moscow that the European Union should to assist with. There is a need to introduce total accounting and control of movement and usage of gas by the principle "from wellhead to burner tip."

Priority 2: Liberalization of the energy sector.

Ukraine's new leadership must set in motion legislation that will help create a competitive energy sector. A liberalized energy sector will attract investments, increase competition and efficiency, and reduce dependency on Russia as a natural gas supplier through diversification efforts. It is imperative that fair prices are ensured at market entry to encourage and facilitate supply diversification.

Enact pricing reform, finding the balance between social costs and economic costs. The new presidential administration must maintain political legitimacy and ensure that the roadmap is followed through. The social costs of end-consumer energy prices must be dealt with proactively, otherwise this could lead to even greater social discontent and political instability. That said, Ukraine should formulate a non-gradualist approach to gas market reform. The gas price should reflect the market reality at every level. A step-by-step approach is more likely to be derailed in its implementation. Market prices will drive efficiency of an extraordinarily wasteful system¹.

Introduce a targeted subsidy system. Ukraine should set up a system in which gas subsidies are tied to lower consumption. For example, consumers should pay lower prices on the first 250 cm/month. The leadership should also fully compensate the price increase to market levels (about 5.5 times for gas and three times for heating) for low-income households by handing out “energy vouchers” worth the value of the average price differential for gas and heating per person. Even if half of the population would receive such a subsidy, the current cost of subsidies would be cut in half, amounting to about \$6 billion. A pricing reform along these lines would preserve social peace and put the bulk of the burden on the more affluent and the current system’s arbitrageurs. It also should allow the government to phase out all the other energy subsidies. The goal is not to eliminate “fossil fuel subsidies” for the population at once but to detach them from consumption, thereby enhancing energy efficiency. The advantage of paying out the subsidy in cash is that this is a considerable stimulus for energy efficiency. It would dramatically increase popular demand for changes to the heating and gas delivery system. The cost of the subsidy would be reduced year by year, in line with energy efficiency improvements.

Initiate an energy savings program. Ukraine has huge potential for energy savings through the realization of energy efficiency programs. Together with increasing domestic gas production and unconventional gas extraction, this will ideally allow the country to dramatically lessen its energy import dependence in the medium term. Ukraine should aim to further reduce gas consumption to 40 bcm from the current 50-52 bcm per year already by 2017-2018. Corresponding energy efficiency programs should be introduced on the regional level, including utilization of local fuel and energy sources for heat generation. The state should introduce a set of financial incentives instead of subsidies to enhance households’ energy efficiency (replacement of roofs, doors, windows, and boilers).

Setting up a microcredit system with the help of international financial institutions (IFIs) to facilitate the investment into efficiency transition will help to reduce consumption and enhancing efficiency in Ukraine’s domestic energy market. Billing has to be changed on basis of the energy delivered and not on the basis of the energy produced in the heating central. This will encourage heating companies to invest in efficiency.

Increase domestic conventional gas production. Liberalizing wellhead prices, providing fair access to market, simplifying licensing procedures, and removing other barriers to investment could substantially increase domestic gas production, further reducing the need for Russian gas supplies.

Complete the restructuring of Naftogaz.

Restructuring and reforming Naftogaz by breaking it up into independent subsidiaries and privatizing its nonessential functions should be a top priority for the new presidential administration. A reform plan should be adopted by the cabinet of ministers as a matter of urgency.

Priority 3: Diversify energy supplies and integrate into the European energy market.

Ukraine should integrate its energy infrastructure into the European energy market as a matter of urgency through interconnections with the regional energy platform of the Visegrad Group (V4). Diversification projects, including reverse flow on the Brotherhood/Bratstvo Pipeline, must be prioritized and facilitated through both European funding and bold steps by Ukraine toward the adoption of a more transparent and stable Ukrainian gas sector. Expanding the Polish-Ukrainian interconnector and building up the necessary pipeline infrastructure to access the Swinoujcie LNG terminal in Poland and enlarging the northern interconnector with Romania should be carefully considered, with the use of EU funding (Projects of Common Interest). In addition to natural gas supply diversification, Ukraine shall also consider diversification of the nuclear fuel supplies and expanding cooperation in the nuclear sector with non-Russian companies.

Priority 4: Stabilize the gas relationship with Russia.

Even as diversification efforts must be pursued vigorously, Russia will remain an important supplier and transit partner for the foreseeable future. Thus, Russia and Ukraine need to stabilize their relationship and agree on a transparent, credible gas purchase contract and transit regime. A prudent and well-prepared negotiation strategy that focuses on the long-term sustainability instead of short-term political gains is a must. Involvement of the European Union and outside industry expertise in the negotiations would facilitate outcomes that conform to modern international business practices. Given the strategic importance of this renegotiation, responsibility should be placed directly in the hands of the prime minister or president.

It should be recognized that the technical competency of incumbents in the Ukrainian energy sector is needed for the negotiations, but some of these individuals have also been barriers to reform and benefited

from corrupt business practices in the past. The continual gas debt to Russia must be resolved once and for all with the help of the international community.

Recommendations for the Transatlantic Community

Close scrutiny of Gazprom's monopolistic contractual practices. The European Union and the Energy Community should redouble and speed up efforts to crack down on Gazprom's monopolistic practices and create a more competitive and liquid European energy market. These are also crucial for Ukraine in its negotiations with Russia and to better access reverse flows through Slovakia, Hungary, and Poland.

Support Ukraine's team in negotiations with Gazprom. Although the primary responsibility to stabilize its energy relationship with Russia lies with Ukraine, the EU shall pro-actively participate in the negotiations to ensure coherence and compliance with European rules and regulations. The EU can help Ukraine boost its leverage by providing a team of experts—including economists, financial experts, lawyers, and energy market professionals—to be in the "back room" with Ukrainian decision-makers during talks with Russian leaders and Gazprom.

Fully utilize international governance institutions.

To build momentum and a better negotiating position vis-à-vis Russia, Ukraine needs to vigorously pursue its use of international governance instruments, especially in light of Gazprom's inflated demands. This offensive should include the Stockholm Arbitrage Court, mediation offered by the Energy Charter, and the World Trade Organization (WTO). Swift action is also needed to demand compensation for energy assets confiscated by Russia in Crimea at all available international courts. To meet the demand for energy efficiency improvements, active international involvement is required through specialized programs and expertise. The focus of the European Bank for Reconstruction and Development (EBRD) on concrete energy efficiency projects is laudable and should be stepped up. Yet the EBRD still lends too much to Russia, and the bulk of that funding could be redirected to Ukraine. The European Investment Bank should also step up funding for Ukraine and redirect more toward energy efficiency and less toward handing out credit lines to other banks.

One central improvement is to install heating and electricity meters on a house or entrance (pod'ezd) basis, as well as on each heating element in the flats (calorific meters). Donating these meters and overseeing their implementation should be a priority.

Set up a "twinning" program. A twinning program between the public administrations of EU member states and Ukraine's new administration could be a vital instrument for cooperation. A twinning program will allow European counterparts to provide support for the transposition, implementation, and enforcement of EU legislation to bring Ukraine closer to the European community. Counterparts will share good practices developed within the EU and foster long-term relationships. European experts with special regard to the Visegrad Four need to be included as advisers in the management of Ukrainian public energy companies.

Strengthen the European Energy Community. The European Energy Community Treaty should be further strengthened by forming a court and upgrading the secretariat with executive functions that would be able to enforce antitrust law, state aid, and merger rules. The Community Secretariat should also assist Ukraine in preparing documents for arbitration in Stockholm.

Medium- and Long-term Tasks for Ukraine and the Transatlantic Community

Medium- and long-term priorities for Ukraine's energy programs should include:

- developing natural gas production from unconventional sources and on the Black Sea waters by involving leading American and European energy companies;
- balanced expansion of the renewable energies (biomass, wind, and solar energy) on a transparent basis;
- enhancing security of the critical infrastructure according to best EU and NATO practices;
- creating strategic fuel reserves in cooperation with neighboring EU member states;
- completing implementation of the EU energy packages in the context of the obligations under the Energy Community Treaty;

- modernizing the Ukrainian gas transit system in close cooperation with the EU;
- transitioning to the European system of natural gas accounting by its quality indicators (calorific value);
- modernizing the national electric power engineering system with its parallel synchronization to the EU;

and

- establishing strategic stocks of oil and petroleum products in accordance with the requirements of the EU and the International Energy Agency (IEA).

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1. An average Ukrainian household consumes 800 cma of gas directly plus almost 1,000 cma via district heating and warm water