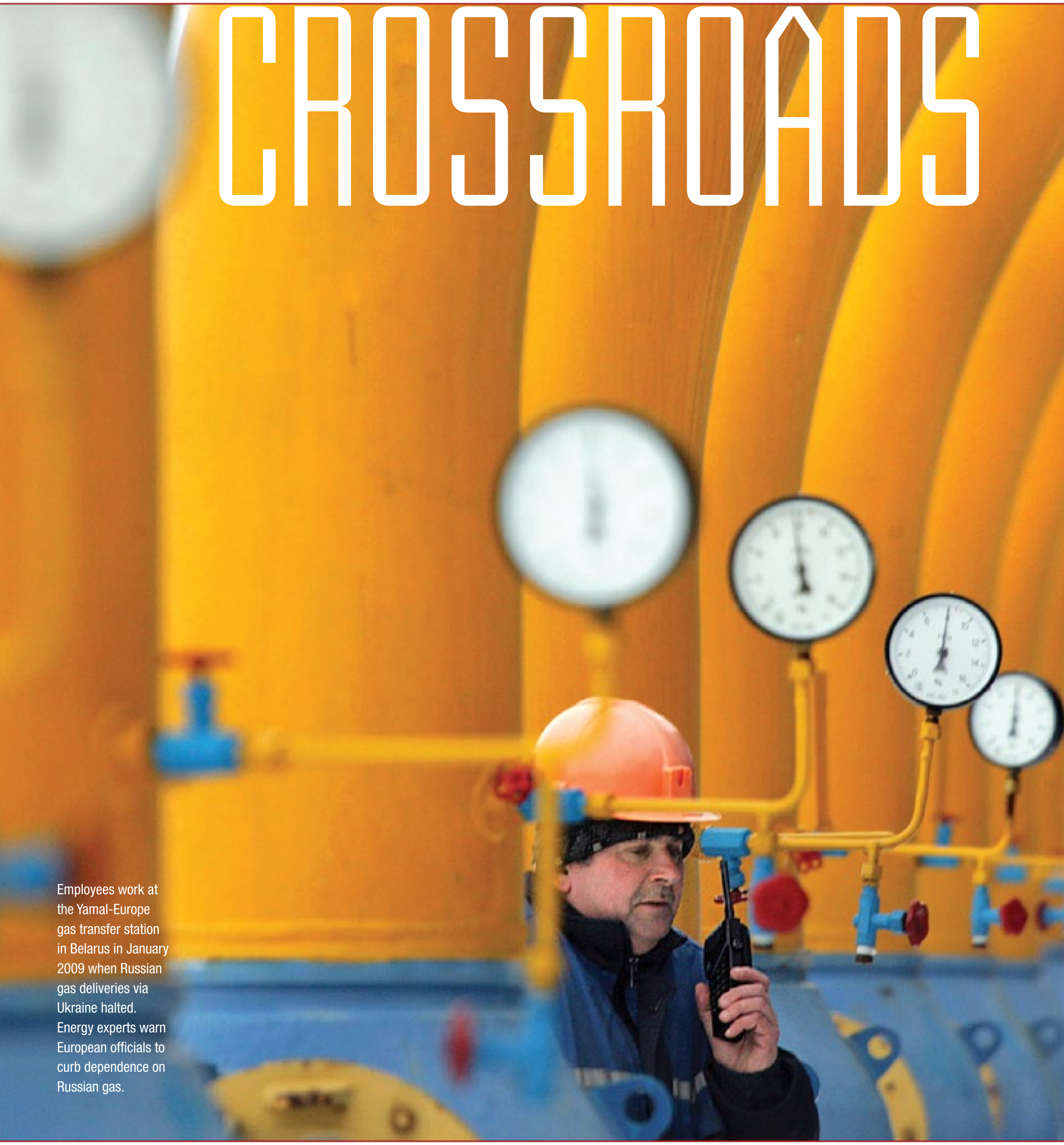
UKRAINE AT A CROSSROADS



Employees work at the Yamal-Europe gas transfer station in Belarus in January 2009 when Russian gas deliveries via Ukraine halted. Energy experts warn European officials to curb dependence on Russian gas.

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THE COUNTRY MUST CHOOSE BETWEEN ENERGY SECURITY AND ENERGY DEPENDENCE IN ITS RELATIONS WITH THE EU AND RUSSIA

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Ukrainian and international experts strongly advise the Ukrainian government that harmonizing energy laws with European Union legislation is the foundation of energy sector reform. Energy sector reform would send a clear signal to international investors and financial institutions to invest in Ukraine in a way that would help modernize the country's energy sector. Ukraine's energy sector reform will involve energy but it will also involve politics. The use of "crossroads" in the title of this article presupposes that Ukraine has options, while the "energy security and energy dependence" phrase invokes an uneasy connotation that these are the only alternatives. But to what extent does this duality match the realities in the Ukrainian energy sector today?

Many were hopeful in December 2005, when the "Memorandum of Understanding (MoU) on Co-operation in the Field of Energy Between the European Union and Ukraine" was signed. This agreement included provisions outlining a clear strategy for Ukraine to reform its internal energy market. The two sides planned to bring their energy markets closer together so that, among other things, their electricity and gas markets could be integrated. To date, it is worth assessing the progress and recognizing the missed opportunities in terms of Ukrainian commitments to cooperate with the EU. It's no less important to look at other international cooperation that best serves the interests of Ukrainian energy security, and to describe threats to the country's energy independence.

UKRAINE/EU COOPERATION

There are four key documents that constitute the basis of energy cooperation between Ukraine and the EU:

- Energy Charter Treaty (ratified by Ukraine in 1998);
- Memorandum of Understanding on Energy Co-operation in the Field of Energy Between the European Union and Ukraine (December 1, 2005; a legally nonbinding instrument);
- Joint Declaration of the Joint EU–Ukraine International Investment Conference on the Modernization of Ukraine's Gas Transit System (March 23, 2009, Brussels; a legally nonbinding instrument);
- Treaty Establishing the Energy Community (ratified by Ukraine in December 2010; effective as of February 1, 2011).

Ukraine and the EU also completed bilateral negotiations on a deep and comprehensive free trade area as part of the Association Agreement on October 20, 2011, in Brussels. The two sides expect that after ratification, the energy package contained in both instruments will enhance energy security in Europe.

The MoU establishes a joint strategy towards the progressive integration of the Ukrainian energy market with that of the EU and consists of road maps covering:

- Nuclear safety
- Integration of electricity and gas markets
- Security of energy supplies and the transit of hydrocarbons
- The coal sector
- Energy efficiency and renewable energy

Both sides agreed there would be annual joint progress reports on the implementation of the MoU submitted to EU–Ukraine summits. There have been six joint implementation reports so far. Surprisingly, the sixth joint implementation report was signed not within the margins of the Ukraine–EU summit, held on December 19, 2011, in Kiev, but on March 22, 2012. The delay was explained by the fact that the two sides had been painstakingly trying to agree on the progress of reforms in the energy sector in the context of the Ukrainian commitments under the Energy Community Treaty (ECT).

This was a sensitive issue for Ukraine because the progress of reforms had to be judged against the implementation of a number of Ukrainian commitments, with deadlines set for January 1, 2012, in the "Protocol Concerning the Accession of Ukraine to the Treaty Establishing the Energy Community of September 24, 2010 (Protocol)."

That it touches on the acute problem of the gas market, in the context of the implementation of the MoU road map on "Integration of Electricity and Gas Markets," makes such an assessment important to the Ukrainian energy expert community. In its turn, the progress there immediately indicates whether the road map on "Security of Energy Supplies and the Transit of Hydrocarbons" can be successfully implemented. This very road map deals with the implementation of the Brussels Declaration of March 23, 2009.

These two road maps do not override the importance of the remaining three. But to talk about successful implementation of the road maps on the "Coal Sector" and "Energy Efficiency and Renewable Energies," much directly depends on Ukrainian Government policy and will in forming an internal single market for electricity and gas. The reason for this dependence on government policy is that adopting alternative energy sources to replace gas is less about Ukraine's energy sustainability than about big Ukrainian business interests closely tied to Russia. For years, financial feasibility and market tools promoting alternative energy sources, in the context of energy sector reforms in Ukraine, have been held "hostage" by dependence on Russian gas imports.

At first glance, the road map on "Nuclear Safety" may seem less market oriented, but its successful implementation is directly linked with the Ukrainian government's plans to boost electricity exports to the EU. Plans to further develop the Ukrainian nuclear sector would depend on a transparent and investor-friendly climate to form a single market for electricity and gas.

To date, Ukraine's energy sector is best described as one that is far removed from market rules and principles. The government's policy to subsidize a number of energy subsectors has been eroding the desire to develop domestic hydrocarbons, raise energy efficiency and stimulate energy savings. These have been very crucial and fundamental problems for Ukraine's economy since the collapse of the Soviet Union, but it became absolutely urgent and demanding to find an immediate solution after the two gas crises masterminded in 2006 and 2009.

In contrast, the energy cooperation offered by the EU to Ukraine relies on transparent rules and principles based on the harmonization of energy legislation. Moreover, after the 2006 gas crisis, the EU recognized it could not build energy security independently without enhancing energy cooperation with non-EU countries. To this end, the importance of Ukraine for the EU can hardly be overestimated. Ukrainian gas and oil transit infrastructure has been the route by which Russia supplies Europe, providing stability and energy security to the region. In effect, Ukrainian infrastructure became part of the EU's economic space long ago.

To the credit of the European Commission, it has given its best effort since 2005 to promote cooperation with Ukraine in the energy sector so that Ukraine can become a member of the Energy Community. The European Commission adopted a communication on security of energy supply and international cooperation on September 7, 2011, in which its energy agenda stressed the importance of relations with third countries once again.

At the time of adoption, Commissioner for Energy Günther Oettinger said the EU and its member states must speak with "one voice" on energy matters: "The EU energy policy has made real progress over the last several years. Now, the EU must extend the achievements of its large internal energy market beyond its borders to ensure the security of energy supplies to Europe and foster international energy partnerships. Therefore, the Commission

German Federal Economy and Technology Minister Philipp Rösler, left, and Norwegian Minister of Petroleum and Energy Ola Borten Moe visit the Sleipner gas platform in the North Sea in 2011. Norwegian gas has been critical to Europe's energy security.

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proposes today a coherent approach in the energy relations with third countries."

Ukraine must urgently define its position with respect to commitments made under a number of concluded instruments on energy cooperation with the EU. Time is running out. The EU is going to open its single market of electricity and gas on January 1, 2015. Therefore, this issue isn't one of idle curiosity for Ukrainians, but rather one of energy sustainability: Shall we or shall we not be a responsible and committed participant in this market?

QUO VADIS, UKRAINE?

The issues mentioned above evoke questions directly related to Ukrainian national interests:

- How will the reforms affect the domestic Ukrainian energy market?
- Can the reforms ensure the energy security and consequently the energy sustainability of Ukraine?
- Will our consumers benefit from the reforms?

These questions relate to a number of looming challenges that must be addressed:

- Objectives to be accomplished to best fit the market and economic environment in the country.
- An energy cost-effective approach based on the transformation of pricing policy leading to the smooth and gradual introduction of cost recovery tariffs for domestic electricity and gas consumers.
- The restructuring of the "Naftogaz Ukrainy" company.
- Full revision of governance in the energy sector that decisively severs corrosive links between businesses and government officials.
- Introduction of a competitive market for all energy sources.
- Introduction of an independent energy regulator.

It is absolutely evident that substantive answers to these questions presuppose transparency and desire on the part of the Ukrainian government to establish and maintain dialogue with civil society. Regrettably, since the Party of Regions came to power in 2010, that is no longer the case. That is why the Ukrainian energy expert community was looking forward to the conclusions of the MoU sixth implementation report for 2011, expecting the EC to provide its unbiased and objective assessment on the integration of electricity and gas markets.

But that did not happen. Instead, the report refers to past achievements and urges Ukraine to comply with its commitments, but carefully avoids the sensitive subject of whether Ukraine is fulfilling its obligations under the ECT one year after it became a member. Ukraine's obligations under the treaty are of paramount importance for energy sector reforms. If Ukraine had complied successfully, it could resolve some fundamental problems, first of all in establishing gas and electricity markets but also granting full independence to the National Energy Regulatory Commission of Ukraine (NERC).

In particular, these obligations refer to the adaptation of EU directives by Ukraine into its internal energy legislation by January 1, 2012:

- Directive 2003/55/EC concerning common rules for the internal market in natural gas;
- Regulation No.1775/2005 on conditions for access to the natural gas transmission networks;
- Directive 2003/54/EC concerning common rules for the internal market in electricity;
- Regulation No. 1228/2003 on conditions for access to the network for cross-border exchanges in electricity.

The protocol set a deadline for eight documents in total, but these four are the most important because their implementation sets the pace for the elaboration of further legislation supporting reforms in the energy sector at large.

To date, one must recognize that much more could have been done since Ukraine became a member of the ECT on February 1, 2011. Nothing prevented the Ukrainian government in early 2011 from launching initiatives by presenting a comprehensive energy package to adopt relevant laws before the end of that year. At this stage, adequate energy legislation is the only prerequisite for reform.

Unfortunately, the Ministry of Energy and Coal Industry of Ukraine cannot report much progress because it has no strategic vision in this area. Its only substantive achievement deals with adoption of the July 2010 law, "On the Principles of Functioning of the Natural Gas Market," in compliance with the EU Directive 2003/55.

Meanwhile the EC keeps urging Ukraine to agree as soon as possible with the Energy Community Secretariat on an action plan and road map for implementation of EU energy legislation under the ECT.

Many renowned analysts agree on one point – if Ukraine does not reduce dependence on Russian gas there will be no energy sustainability and independence for the country at all.

The Ministry of Energy and Coal Industry of Ukraine has seemed reluctant to push forward with the draft laws "On Principles of Electricity Market Operation in Ukraine" and "On State Regulation in the Energy Sector of Ukraine," adoption of which is long overdue. The delay in the adoption of the electricity law proves by default that Ukraine has failed to comply with its obligation to ensure that all nonhousehold customers become eligible within the meaning of EC Directive 2003/54/EC from January 1, 2012. "On State Regulation in the Energy Sector of Ukraine" has been in preparation since 2007. Adoption has taken so long because no Ukrainian government, regardless of political affiliation, is ready to defend open market principles in which a fully independent regulator defines pricing and controls services provided by and to companies, ensuring a balance of interests between producers, transport/transit operators, consumers and the state. For bureaucrats, the worst that can happen is allowing NERC to become independent. An independent NERC could guarantee fair prices to consumers, penalize manipulation through tariffs and transport fees, and secure diversified access to energy for everyone without giving benefits or preferences to a particular supplier.

The EC stresses in the sixth MoU implementation report that "the effective independence of NERC is long overdue and an important requirement in order to fulfill Ukraine's Energy Community obligations." This is more than true. Without a fully independent regulator, Ukraine cannot fulfill its obligations under the ECT with regards to EC Directives 2003/54/EC and 2003/55/EC, which require that Kiev implement the EU's second energy package, i.e., to unbundle functions of energy suppliers and network operators.

But on June 13, 2012, three months after the joint implementation report, came the Decision of the Cabinet of Ministers of Ukraine, No. 360-p "On the reorganization of subsidiary companies of Naftogaz Ukrainy," a move that stunned independent energy experts. The decision notes that Ukrtransgas (system gas operator) and Ukrgazvydobuvannya (gas producer and supplier) shall be separated from their mother company, Naftogaz Ukrainy, making them public limited companies (PLC). As far as PLC Ukrtransgas is concerned, the change made it compliant with the EU Directive 2003/55/EC, i.e., the unbundling of Naftogaz Ukrainy. That technically made it fall under the EU's second energy package. But a surprise emerges a few lines below, where the decision notes that the newly "independent" PLCs will be managed by Naftogaz Ukrainy upon agreement with the Ministry of Energy and Coal Industry. The decision indirectly proves that without a fully independent energy regulator there can be no independent energy operator. In short, reforms in the energy sector of Ukraine cannot be effective unless they are firmly rooted in an adequate legal system.

WHAT IS AT STAKE?

Energy security in Ukraine requires the supremacy of law ensuring transparency, a favorable investment climate for market participants and financial institutions, and consumer protection against market manipulation and distortions. There is little alternative to the EU agenda. To go the other way would mean sacrificing national economic interests to benefit big business and corrupt government officials. Such a dilemma is absolutely

EU Commissioner for Energy Günther Oettinger, right, and Ukrainian Energy Minister Yuriy Boyko address the media after meeting at the Commission headquarters in Brussels in May 2010.

THE ASSOCIATED PRESS

unacceptable for Ukraine because it offers nothing but energy dependence. The core of the problem is gas, namely imported Russian gas.

Many renowned analysts agree on one point – if Ukraine does not reduce dependence on Russian gas there will be no energy sustainability and independence for the country at all. This problem is aggravated by the fact that Russians persistently link gas supplies to the EU with Ukrainian consumption of imported Russian gas. It is not the purpose of this article to analyze Ukrainian–Russian relations, but one cannot avoid assessing the overall impact of this state of affairs on the progress of energy sector reforms, the key component of which is restructuring Naftogaz Ukrainy.

To restructure the company in compliance with Ukrainian commitments under the ECT means to apply provisions of the EU Second energy package. Moreover, the 9th Energy Community Ministerial Council, by its decision of October 6, 2011, invited Ukraine "to expedite the internal procedure of approval" to amend the ECT with the EU directives and regulations promoting the third internal energy market package. But Ukraine has not yet responded positively, seemingly taking time out because the current government is still relying on the possibility of achieving progress with Russia in reducing prices for gas imports. But the pace of these "renegotiations" is sluggish and a solution elusive.

Russia's Gazprom has been trying for years to reach a deal with Ukraine to take over its Gas Transport System (GTS) and underground gas storage facilities. But if the second and third energy packages come into force consecutively in Ukraine, it would be illegal for Gazprom to manage Ukrainian GTS in any capacity. In fact, Russian ownership has been forbidden since 2010 in accordance with the law, "On the Principles of Functioning of the Natural Gas Market." By adopting the third energy package, the EU has made a revolutionary step – to refocus its energy policy away from companies in favor of consumers.

Gazprom cannot bear such changes. Its notorious reaction to the application of the third energy package in the EU has already demonstrated how removed the Russians are from market principles and rules. Instead, Russians are trying to exercise political instruments in their energy policy, especially in relation to countries most dependent on their gas and oil supplies. Russia is very pragmatic in its final objectives – an economic "divide and conquer" strategy aided by local plutocrats.

A Russian oil platform towers over a shipyard in 2011. The platform will serve the Korchagin oil field in the Caspian Sea, a major source of Europe's energy.

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Where are we now? Brussels repeatedly insists on Ukraine being faithful to its commitments after concluding the bilateral deals. The Ukrainian government is trying to make a gas price reduction deal with Russia but remains dependent on the Kremlin's whims. This long process of negotiations without results proves that gas prices are not the issue. The issue for Russia is to dominate Ukraine politically. Moscow keeps saying that the Ukrainian economy is stagnating and that only Russia can help save Ukrainian gas infrastructure from collapse by acquiring its assets. But at what price? Regrettably, the Ukrainian government has walked into this well-laid trap by inviting a foreign company to evaluate the GTS.

The current Ukrainian government strongly believes that after the evaluation of the GTS it would be possible to propose a tripartite consortium to manage the system with the participation of Gazprom and European companies. Are government officials unaware of the second energy package provisions contained in "On the Principles of Functioning of the Natural Gas Market"? Gazprom certainly is. It has already indicated that if it assumes management of the Ukrainian GTS no other partners are needed. In their turn, European companies are unlikely to join the management of the GTS to make a partnership with a gas monopoly of shocking reputation.

A NEW APPROACH

The evaluation of the GTS is a waste of money. Instead, there should be a fully independent Ukrainian gas operator that will decide what type of corporate partnerships it needs. Its functions have nothing to do with the price of gas to be transitted or transported. Gas supply contracts with Gazprom can no longer be linked with the transit obligations of the Ukrainian independent gas operator. If the EU third package is applied in Ukraine, it would open the possibility of European companies buying Russian gas on the Ukrainian–Russian border. That opens up an absolutely new dimension for the participation of European companies and international financial institutions in the modernization of the Ukrainian GTS in the context of the Brussels Declaration of March 23, 2009.

Given what is mentioned above, it's worth noting that the root cause of the 2006 and 2009 Russian–Ukrainian gas crises was the simple and legitimate wish of Naftogaz Ukrainy to conclude gas supply contracts not linked to the price of oil and transit fees. Disagreements with Russia over gas prices were effectively turned by Gazprom into problems with the alleged failure of Ukraine to comply with its transit obligations. Once applied in Ukraine, the EU third energy package will eliminate this problem.

It is clear that the key object of Ukrainian energy sector reform is Naftogaz Ukrainy. The Ukrainian energy sector is riddled with problems, but the worst are subsidies, cross-subsidies and nonmarket pricing policies in the gas subsector. All three are detrimental to the Ukrainian economy because they subsidize imports of Russian gas, thereby penalizing domestic production of hydrocarbons. Paradoxically, this is why the big, corrupt Ukrainian gas business is amenable to high Russian gas prices – state subsidies and cross-subsidies will always secure its profits, unlike open markets.

On the other hand, reforms will compel the government to spend more money. But where will the money come from? The only answer is the redistribution of gas subsidies that have been injurious to the state budget. The government should provide a compensatory social safeguard only for the most vulnerable energy consumers. Ukrainian experts estimate this new arrangement would cost the government three times less than continuing its annual subsidies to Naftogaz Ukrainy.

The EU is ready to grant Ukraine access to its energy market by assisting with expertise and funding the most promising integration project to date – the Synchronous Interconnection of the Ukrainian and Moldovan Power Systems with the European Network of Transmission System Operators for Electricity. If the modernization of the GTS goes well, a project to synchronize the Ukrainian GTS with the European Network of Transmission System Operators for Gas would follow. The two projects are the first to lay a true foundation for a Ukrainian energy independence that would also add to Europe's energy security. The only preconditions for success are legal protection for companies and investors and the adoption of free market principles in Ukraine.

The synchronous exchange of electricity and gas creates a real opportunity for the diversification of energy supplies so that the EU could supply Ukraine in a reversed mode of operation. The Ukrainian government's diversification measures include launching a domestic liquefied natural gas project; granting concessions to Shell and Chevron to develop nonconventional natural gas resources, including shale gas; and signing a memorandum of cooperation with the German company RWE to buy gas from the European spot market via Slovakia.

These diversification projects do not eliminate the necessity of establishing a solid legal foundation in Ukraine for investors and international companies. Successful reforms will only facilitate the consolidation of market principles. Keeping in mind the prospective synchronization and diversification projects, one should hope that Ukraine does not set aside the EU offer for energy market integration. Two more years remain before the EU inaugurates its single market for electricity and gas. Perhaps that's too little time for Ukraine to complete fundamental reforms, but it is definitely possible within this period to provide the necessary framework for international companies and investors.

The Ukrainian government claims that the country is not at a crossroads between energy security and energy dependence. The results of parliamentary elections in October 2012 and Russia's intent to start building the notorious South Stream pipeline in December 2012 may determine the validity of that claim. Europe can't afford another gas crisis emanating from Moscow. □

Information current as of September 2012.