



Analyst's Notebook

Ukraine/Electricity
 March 9, 2006

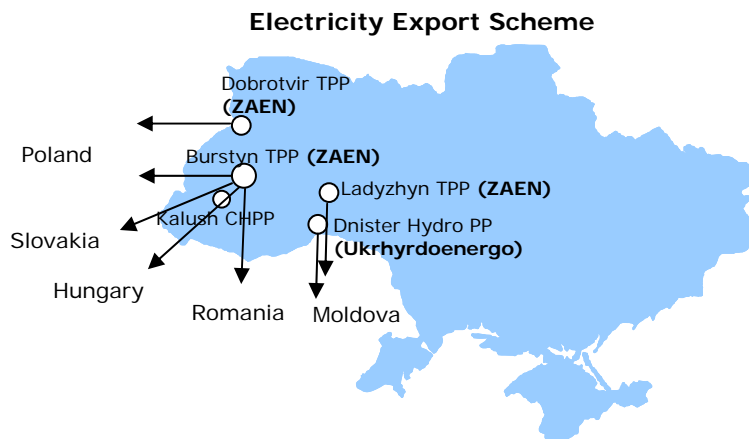
Electricity Exports: Liberalization By Fire

In a nutshell: The conflict surrounding energy export monopoly Ukrinternergo (UIE) has shifted from the polemic about the efficiency of UIE and its management to a near-military conflict similar to the situation we have been witnessing in the Oblenergos controlled by Grigorishin/Surkis/Kolomoiskyi.

Earlier this week officials from the Ministry of Fuel and Energy made an attempt to replace the director of UIE, Oleg Bugayev with their protégé Igor Drozdov. Bugayev accused the Ministry of interfering in the company's business in order to increase control of the Ministry over electricity export contracts. In response, a deputy Fuel and Energy Minister suggested **de-monopolizing electricity exports**.

In our opinion, the de-monopolization of electricity exports will put an end to all the conflicts surrounding UIE and increase the efficiency and flexibility of Ukrainian exports.

Who will export electricity? Currently all the exports of electricity to Poland, Slovakia, Hungary, Romania and Moldova is done by UIE, while physically all the exported electricity is produced by the power plants of Zakhidnergo (**ZAEN: BUY**), Kalush CHPP (owned by the local administration) and Dnister HPP (owned by Ukrhydroenergo).



However, all these companies *de-jure* sell their electricity to the wholesale market, and where UIE buys it.

If exports are liberalized, ZAEN and Ukrhydroenergo can start exporting electricity by themselves, benefiting from direct contracts with international traders.

Is liberalization feasible? UIE's export monopoly gave it economy of scale, making it the only company that could accumulate cash for export contracts, and use this money for improving the quality and stability of export supplies (e.g. subsidizing upgrades of export capacities). Thus, gaining economy of scale was the main economic reason for UIE's monopoly. However, with the subordination of Dnister HPP to Ukrhydroenergo (operating all the largest hydro PPs in Ukraine) in 2005, now economy of scale does not look to really benefit UIE. Currently the two largest producers of electricity for export, ZAEN and Ukrhydroenergo are large enough companies to deal with their exporting capacities by themselves.

Thus, there is no economic reason for UIE's monopoly status. The only problem is political will. We believe the growing conflict surrounding UIE, will lead the Ministry of Fuel and Energy to push for export liberalization.

There is a good chance that the change in government following the March 26 parliamentary elections may weaken the position of those supporting liberalization. However, we expect their position to remain strong enough to implement the liberalization idea, as in the National Electricity regulation Commission (NERC) there exists many people supporting current policy of the Ministry. These people are unlikely to be shifted after the elections, because the NERC is a non-political structure.

WATCH: Will ZAEN receive an export license in 2006?

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