



Alexander Paraschiy  
 ap@concorde.com.ua  
 +380 44 207 5037  
 www.concorde.com.ua  
 Bloomberg: CONR<GO>

## Analyst's Notebook

Ukraine / Electricity  
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### *Ukraine Preparing to Produce Power for Russia*

A meeting last weekend between Ukraine's energy minister, Yury Boyko, and Andrey Rappaport, a member of the board of Russia's national electric power company, RAO UES, has given fresh impetus to plans to revive exports of Ukrainian electricity to Russia. The plan involves introducing a tolling scheme in which Ukrainian plants would produce electricity from Russian gas.

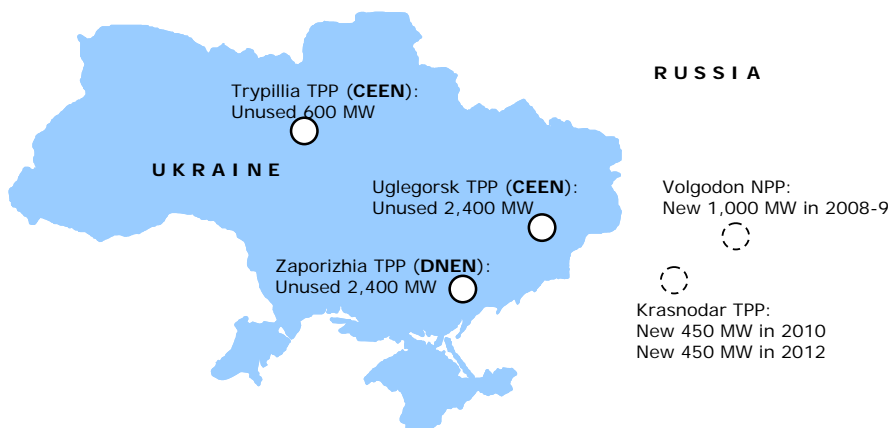
If the project is implemented, it would allow Ukraine to renew operation of some of the gas-fueled thermal power generating capacity that has been idled due to increased gas prices. In particular, the plan would likely make use of an 800 MW power unit of Uglegorsk TPP operated by Centrenergo (**CEEN: Hold**). Since news of the tolling plan surfaced in early September, Centrenergo's mid-market price has increased almost 18% on the PFTS. This week legislation was introduced in Ukraine's parliament to make the scheme possible. We expect Russia and Ukraine to start this scheme in early 2007 at the Ulegorsk unit.

However, we do not see any significant benefit for CEEN, other than an increase in the of amount of electricity produced. It is also possible the plan won't be implemented. The scheme would depend on the gas being supplied at Russian domestic prices, which Gazprom might not accept.

### *Exporting Ukrainian Power to Russia Makes Sense*

Due to a lack of generation capacities in Russia and excess capacity in Ukraine, it would be more efficient for both countries to employ more Ukrainian power plants. Russia, which stopped importing Ukrainian electricity a year ago over a price dispute, has an increasing energy capacity deficit, and is unlikely to commission any new capacities before 2009. So Russia is likely to renew imports of Ukrainian power.

#### Illustration: Idle Ukrainian Capacity Could Be Useful For Russia



### ***An Opportunity for Ukraine to Pass Some Costs to Russia?***

The effect for Ukraine's economy is less straightforward. According to the former director of the Uglegorsk TPP, Oleg Panasovsky, who is a member of Ukraine's parliament and one of the main backers of the tolling plan, each idle gas-fueled power unit costs about USD 2.8 mln a year to maintain.

These costs are factored into the price of electricity produced by GenCos, which means Ukrainian consumers pay for the idle capacity. Now there is an opportunity that Russian consumers will share these costs with Ukrainian consumers.

### ***A Link to Power Sector Privatization Plans?***

The excess USD 2.8 mln spent by energy consumers is less than 0.1% of the total value of electricity consumed in Ukraine. Thus, employing one power unit would not be noticeable for the Ukrainian economy. Does this suggest that the powers that be have a particular interest in helping CEEN?

Panasovsky, an MP for the Regions party, certainly does, as the workers of Uglegorsk are his electorate. He recently introduced a draft law that would allow the sale of electricity produced by gas-fueled power units under an international tolling contract to bypass Ukraine's wholesale market.

However, the governing Regions party is more likely to be interested in CEEN than in just the Uglegorsk unit and its workers. There could be a link between the tolling plan and a recent plan from the State Property Fund to privatize small stakes in thermal generators (GenCos), and recent comments from Cabinet leaders that they are considering full privatization of GenCos.

### ***What About Gazprom?***

Although Russia arguably should be interested in implementing the project, the government does not appear to be in any rush to implement the agreement. The problem is that it would require Gazprom to grant an exception to its practice of supplying all gas to Ukraine at a fixed price which is significantly higher than gas prices in Russia. RAO UES has confessed that it does not know if it can get gas from Gazprom to supply Ukrainian power plants.

### ***Imported Ukrainian Electricity Wouldn't Be Cheap***

The most crucial problem is the price of Ukrainian electricity for Russia. One year ago Russia stopped buying Ukrainian electricity because the price of USD 23 per MWh was too high. The price of electricity produced at Uglegorsk and supplied to Russia is likely to be about the same.

The average production costs of Russia's Stavropol TPP (which uses the same technology as Uglegorsk's gas units and is located close to Uglegorsk) is USD 23.4 per MWh. The Stavropol TPP bought gas in 1H06 for USD 60.3 per ths cm (excluding transportation tariffs).

If we assume Russia will be able to supply gas to Uglegorsk at the same tariff as to Stavropol, Uglegorsk could buy gas at USD 71 USD per ths cm (including Ukrainian transportation tariffs).

Adjusting Stavropol's production costs according to Uglegorsk's assumed gas tariff, and other costs not related to the main activity of power units (taxes, interest expenses, rent and others), we estimate the production costs of Uglegorsk TPP to be USD 21 per MWh. If we also add electricity transmission costs from Uglegorsk to the Russian border (Ukrenergo's tariff will equal USD 2.03 USD per MWh), the final price of Uglegorsk's electricity for Russia would be about USD 23/MWh.

Does Russia need such "expensive" electricity? If they really lack capacity, then the answer is yes.

***Ukraine Could Offer a Discount***

Uglegorsk could sell its electricity to Russia at a discount, so that its income only covers its variable costs. Ukrainian regulators could agree to produce electricity for Russia at Uglegorsk, even if its electricity price did not fully cover Uglegorsk’s fixed costs (the fixed costs exist in any case, and Ukrainian consumers pay them now anyway). In this case, the final price of electricity at the Russian border could be USD 20 per MWh.

Thus, we expect the final price of electricity produced at Uglegorsk’s gas power units could be between USD 20 per MWh and USD 24 per MWh (the latter with some margin for CEEN). Much would depend on the lobbying power of the Ukrainian and Russian parties.

***The Impact on CEEN: More Output, but No Significant Extra Profits***

If the tolling agreement is implemented, CEEN would definitely increase its power load and its total electricity output.

Also, we expect that CEEN would, at least, cover all its production costs at one gas-fired power unit. However we do not expect any significant margins for CEEN’s bottom line from tolling. The company’s regulated tariffs already compensate for the costs of maintaining idle units, whereas with a tolling scheme, those costs would be compensated by Russia. It’s doubtful that Russia would allow for any additional profit.

Therefore, we believe the market over-estimated the positive implications for CEEN from the possible tolling agreement. We retain our HOLD recommendation.

**CEEN Stock Price, USD**



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