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Analyst's Notebook

Ukraine / Electricity
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Energy Sector: Questions Raised by Recent Events

Since the creation of the new government, the series of events that have taken place in the energy sector could not help but draw our attention to several trends. We have arranged events chronologically in order to make preliminary conclusions on what we can expect in the future.

People Close to Donetsk Businesses are Increasing Their Influence

In Sector Regulators...

In August, right after the election of the new Prime Minister, key positions in energy sector regulators were replaced with people close to Donetsk business groups:

Aug. 6: Minister of Fuel and Energy (strategic regulation, financing)

Aug. 17: Head of the National Electricity Regulation Commission (licensing and tariff policy)

Aug. 17: President of the National Energy Company of Ukraine (NC ECU) (control of state stakes in GenCos and Oblenergos)

Aug. 18: Director of the State Enterprise Energorynok (wholesale energy market operator: control over cash flows)

Among key state positions in the electric power sector, only the top management of the State Enterprise Ukrenergo (the dispatcher) has not changed since August.

And in Energy Companies...

Late September: CEOs for two Oblenergos (ZAON, DNON) were replaced.

Oct. 6: CEO of Centrenergo was replaced.

Oct. 7-9: EGMs of ZAEN, CEEN, DOEN were called for **Nov 21-23**

Oct. 10: KIEN EGM: System Capital Management (SCM) allies joined the supervisory board as representatives from the NC ECU

Oct. 1-18: EGMs for many state-controlled Oblenergos (ZAON, VOEN, CHEN, HAON, VIEN, DOON) were called, which are to be held in **Nov.-Dec.**

(Note: DNEN is in the process of financial recovery, which means no shareholders meetings can be held)

The main agenda items at the EGMs are to change the companies' supervisory boards and audit commissions, where people from the "old, orange power" are present. Soon after the EGMs, we also expect top-management to be purged of people not supporting the interests of these Donetsk groups.

While government control over state companies is natural, rapid changes in the bodies that control these companies is peculiar, especially since each company already has representatives from the government and the NC ECU on their boards and other governing bodies. However, the goal of the Donetsk businessmen is becoming more clear: to leverage their presence in the government to get control of state-owned energy companies. In other words, Donetsk people want to see *their* representatives in state-controlled companies. The results of Kievenergo's recent EGM support this theory.

Socialists and the President Insist on Privatization

Sep. 6: SPF proposed privatization of small stakes in state-controlled Oblenergos and GenCos

Sep. 12: Russian RAO UES said it wants to take part in privatizations in Ukraine

Oct. 5: The Minister of Fuel Energy criticized the SPF's plan to sell small stakes

Oct. 10: The President signed a decree canceling a prior decree that created the NC ECU

Oct. 12: The Prime Minister criticized the President for issuing the decree on the NC ECU

Oct. 12: Parliament Speaker Olexander Moroz and his Russian counterpart discussed co-operation in the electricity sector

Oct. 18: The Cabinet amended its decree on creation of the NC ECU; therefore NC ECU exists by the order of the Cabinet

Oct. 24: Russian Prime Minister Mikhail Fradkov is expected to discuss co-operation in the energy sector during a visit to Ukraine

The SPF's move to privatize minority stakes of GenCos and the Presidents' action to disband the National Energy Company are both aimed at decreasing the concentration of power in the hands of businessmen with ties to Donetsk and to somehow balance control of the energy sector.

If either the privatization were approved or the NC ECU were disbanded, control over the energy companies would fall to the State Property Fund, which is controlled by the Socialists, and people close to the Donetsk business group would be prevented from seizing total control over the energy sector.

Not surprisingly, the Yanukovich-led government has started to criticize these moves. The government, the key decision-maker in this case, wants to postpone the privatization process. At the moment, Donetsk businessmen close to the government already control most of the companies in the energy sector *de facto*.

Russian Entry into the Market Encouraged as a Counterbalance

As a counterbalance to the growing influence of the Donetsk group, the Socialists might be willing to allow Russian companies to take part in the privatization of Ukrainian energy companies. Moroz's recent visit to Moscow and statements from Russia's RAO UES support this notion. The President is also likely to support the entrance of a powerful competitor into the sector.

Ukraine could use RAO UES's participation in the privatization of Ukrainian energy companies in exchange for some concessions during negotiations with Russia over gas import prices. In any case, the final decision on privatization depends on the government, which we think has enough reason to postpone the privatization and continue supporting the expansion of Donetsk businessmen's influence in the sector.

Implications for the Future

In case the privatization is postponed and the concentration of power continues, the only positive implication is that the new government might have a plan to solve the energy sector's main problems and is appointing the people it needs to implement this strategy.

If power over the whole sector is concentrated in the hands of one business group, it will lead to a decline in corporate governance, competition and efficiency. Moreover, it makes the state-owned energy companies the hostage of this group, who might not necessarily have good intentions about increasing the companies' value.

Trade Off for Donetsk Businessmen

The SCM business group, which is close to the government, is one of the main candidates to win any future privatization tenders for majority stakes in Ukraine's power generation and distribution assets. The Government has a clear conflict of interests: on one hand, it must increase stability in sector companies while on the other hand the people now in control represent the interests of SCM, who are interested in privatizing the assets at the lowest possible cost.

SCM has a trade-off between the temptation to privatize the power assets at a low value (via bankruptcy or shadow privatization) and positioning itself as a transparent company with high corporate standards. The rapid moves to change the management in energy companies might be a sign of preparations for privatization in the sector. Since buying energy assets cheap is tempting for SCM and for RAO UES (as the government is trying to establish good relations with it), transparency may be an issue in the privatization process.

Debt Offsetting Process: The Deadline Is Approaching

Jan. 1, 2007: Moratorium on energy companies' bankruptcy is lifted

Historically, the easiest proven way to privatize companies at a low cost in Ukraine is through bankruptcy.

On Jan. 1, 2007, the first period of the debt-offsetting process will end. Until this date, bankruptcy processes in energy sector are banned, but afterward, any company which has not written off or restructured its debts can be bankrupted. As of July 2006, we did not see any significant decrease in GenCos' debt, and since then we have not seen any news indicating recent progress on debt restructuring. That means increasing bankruptcy risk. What happens during the remaining time before the deadline will show the government's real position.

While there are a long list of reasons why bankruptcy is unlikely (including opposition from institutional shareholders, the President, and pressure from representatives of international capital markets), we think that such risks should not be ignored.

If the government and the companies' new management intend to avoid bankruptcies of energy sector companies, there should be a significant decrease in CEEN's or DNEN's debt in 2H06, or the moratorium on bankruptcy will be prolonged. We will continue to watch the situation closely.

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