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Ukraine's First Year in the Energy Community: Restart Needed

Signing up to the Treaty Establishing the Energy Community on 1 February 2011, was the first institutional and legal dimension of Ukraine's European integration process. Of note is a serious dispute between the Ukrainian government and the Secretariat of the Energy Community, which has marked the end of the first year of Ukraine's membership of the organisation. Both sides have accused each other of not fulfilling their mutual obligations. Ukraine's deputy minister of energy Volodymyr Makukha has declared that Ukraine did not receive the expected support from its European counterparts in terms of improving the country's energy security.¹ On the other hand, the director of the Energy Community Secretariat, Slavcho Neykov, has underlined, that the Ukrainian government did not provide the Secretariat with sufficient information regarding the process of implementing obligations arising from the Treaty.²

The situation demonstrates that there is a certain level of misunderstanding between Ukraine and the Energy Community in terms of the purposes of the organisation. This paper is an attempt at assessing the actual progress made by Ukraine during the first year of its membership of the Community. The progress achieved by Ukraine in terms of compliance of internal norms with the Energy Community *acquis communautaire* represents a convenient opportunity to verify the extent to which political declarations correspond with actions. On this basis, this paper will try to identify the main problems that may influence future relations between the EU and Ukraine in the sphere of energy and – more generally – the future of the country's European integration process.

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¹ Oleg Gavrish, Dmitriy Belikov, "Truba zovet," *Kommersant Ukraina*, 6 December 2011, www.kommersant.ua.

² "Slavcho Neykov: My ne otrymuyemo informatsiyi vid Minenergougillya," *Ukrayinska Energetyka*, 27 January 2012, www.ua-energy.org.

The Energy Community: The EU's Regulatory Framework Going Beyond its Borders

The Energy Community Treaty was signed in October 2005 by the European Community, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Montenegro, the Former Yugoslav Republic of Macedonia, Romania, Serbia and the United Nations Interim Administration in Kosovo on behalf of the latter. The new regional organisation was established on 1 July 2006, when the Treaty came into force for a period of 10 years. The Energy Community participants agreed to establish a unitary legal and economic framework, organising their mutual relations in the field of so-called Network Energy (i.e. the electricity and gas sectors), based on the EU's *acquis communautaire* regulating such fields as gas and electricity markets, environmental issues, competition and renewable sources of energy.

The Energy Community should also be regarded as a mechanism for supporting the implementation of the EU's energy policy goals. The latter is aimed at ensuring security through creating an internal, liberalised and integrated gas and electricity market, in which transmission functions are separate from generation and sale operations. Competition is believed to be the key to ensuring energy security. These goals are now defined in the so-called EU third energy package, which came into force in March 2011. However, even if the EU's internal gas and electricity market is set up according to these principles, it will remain vulnerable to external turbulence in neighbouring countries. The latter often play an important role in terms of supply or transit of energy to the EU. Therefore, the EU endeavours to extend its energy regulatory framework beyond its borders, and the Energy Community appears to be one of "transmission belts" of such an operation. Indeed, in October 2011, the Energy Community members decided to adopt the EU's third energy package as a part of the Treaty *acquis*. These provisions are to be implemented by January 2015.³

Ukraine's Network Energy Sector: An Unreformed Source of Fortune

Ukraine's membership of the Energy Community became an important and, at the same time, the most challenging, element of the organisation's development, due to the lack of significant reforms in the country's energy sector in the years since it gained independence from the former Soviet Union. As a result of rent-seeking exploitation, it became one of the main sources of oligarchic fortunes, but at the same time remained seriously lacking in investment. The Ukrainian economy is highly energy-intensive.⁴ The Ukrainian gas and electricity sectors, both of which are the main subjects of the Energy Community Treaty, are based on an outdated Soviet-era infrastructure. Due to lack of significant reforms by the eve of Ukraine joining the Energy Community, they were very few free market mechanisms in place. It is thus hard to imagine Ukraine's economic and political

³ The text of the Treaty and *acquis communautaire* constituting the Energy Community's legal framework can be found at the website of the organisation: www.energy-community.org.

⁴ According to the International Energy Agency, the Ukrainian economy's energy-intensity is 16 times higher than in the case of Germany and 7 times higher than in the case of Poland.

modernisation without the prior introduction of transparency and free market principles to its energy sector.

From the EU's perspective, the Ukrainian natural gas sector is an especially important factor for its own energy security. The country is one of the biggest consumers of natural gas in Europe⁵ and an important gas transit player – most of Russia's natural gas exports to the EU are transported through the Ukrainian gas transportation system (GTS). The gas sector in Ukraine is regulated by law, on the principles of the functioning of the natural gas market, adopted in July 2010. The act created a basic legal framework for the introduction of a competitive gas market in the following years. In practice, however, the market remained under control of the national joint stock company Naftogaz, with the state owning 100% of its shares. Naftogaz is organised as a vertically-integrated holding with a number of subsidiaries carrying out operations in the gas industry.⁶ These include production (Ukrasproduction, Chornomornaftogaz), transmission (Ukrtransgaz), distribution (Gas of Ukraine), and technical support (Ukrnaftogazkomplekt, Naukanaftogaz, Naftogazbezpeka).

The development of the Ukrainian gas market is largely influenced by the dependency on gas imports from Russia. In 2011, Ukraine's own gas production met around one-third of internal demand. High gas prices fixed by the agreement between Naftogaz and Gazprom in 2009 provide Russia with significant leverage. Russia is trying to take control of the Ukrainian GTS, hampering the latter's attempts to liberalise the gas market and diversify sources of gas supply. Furthermore, Russia's recently established North Stream project, and its planned South Stream project, are used as an argument to reduce the value of the Ukrainian GTS thanks to its loss of significance as a conduit in Gazprom's trade with EU consumers.⁷

Ukraine is also one of the biggest producers of electricity in Europe.⁸ Ukraine's electricity system is partially integrated with the European Network of Transmission System Operators for Electricity (ENTSO-E) through the so-called Burshtyn Island, an isolated network of power station and substations in Burshtyn, western Ukraine. It exports electricity to the countries of Eastern and Central Europe (Moldova, Hungary, Slovakia, Poland and Romania). Ukraine's electricity sector remains regulated by the 1998 law on electricity energy industry. The market is organised in accordance with a single buyer model, with the state-owned company Energorynok fulfilling the role of buyer. Such a manner of market organisation simplifies price regulation, but does not stimulate transparency, efficiency and competition. Electricity transmission is operated by the state company NEC Ukrenergo, while

⁵ According to BP, in 2010 Ukraine consumed 52.1 bcm of gas, which is close to the level of consumption of such countries as France or The Netherlands.

⁶ Naftogaz operates in the oil sector as well.

⁷ Igor Lyubashenko, "Ukrainian-Russian Gas Negotiations: Consequences for the European Union," *PISM Bulletin*, 5 March 2012.

⁸ According to the International Energy Agency, in 2009 Ukraine's production of electricity was about 1.5 times higher than the EU-27 average.

distribution is controlled by 27 regional companies (Oblenergo). Electricity export is controlled by the state-owned Ukrinterenergo.

Ukraine's Motivation for Entering the Energy Community

The process of Ukraine's affiliation with the EU on energy issues started in 2005. In December of that year, President Yushchenko signed a Memorandum of Understanding on co-operation in the field of energy, between the EU and Ukraine, which provided the basis for adoption by Ukraine of key elements of the EU's energy-related *acquis communautaire*, and in particular for the integration of gas and electricity markets. In March 2009, a joint declaration was signed, between the government of Ukraine, the European Commission, the European Investment Bank, the European Bank for Reconstruction and Development and the World Bank. According to this declaration, the signatories declared their readiness to provide the necessary investments for modernisation of the Ukrainian GTS, upon the reformation and liberalisation of Ukraine's gas market. These declarations have not so far been executed. Furthermore, in July 2010, a new law on the principles of Ukraine's internal and foreign policy defined political, economic and legal integration with Europe as one of the country's priorities. Signing the Energy Community Treaty could thus be regarded as a logical step towards greater co-operation between Ukraine and the EU on energy issues.

However, the declared strategic goal of integration with the EU, and the will to impose its rules of the game on Ukraine's internal energy market cannot be regarded as the primary motivation to join the Energy Community. The Community's ultimate goal will be achieved in the long-term. Signing the treaty led to strictly defined mutual obligations, and carries significant costs of adjusting with it, especially on the Ukrainian side. At least two goals of a rather short-term tactical nature should be taken into account. Firstly, the fact of being a contracting party of the Treaty became an additional mechanism supporting Ukraine's position on gas in its relations with Russia. The transit and internal supply functions of the Ukrainian GTS are integrated. As a result, it is in of vital interest to the Ukrainian political and business elites to keep control of the GTS in order to prevent Russia from dictating gas prices to the country's internal customers. At the same time, the predominantly oligarchic nature of Ukrainian capital is not favourable for large-scale and long-term investments. The EU as a part of the Energy Community is regarded as a potential source of the investments necessary for the modernisation of the Ukrainian GTS, as well as a partner capable of preventing Russia from developing its South Stream project, which is considered by the Ukrainian authorities to be the main threat to Ukraine's position as a transit country. Indeed, precisely these goals were mentioned on the occasion of the dispute with the Energy Community Secretariat. Secondly, having some electricity production surplus, Ukraine is also interested in extending the scope of electricity export. The EU's introduction of Carbon Emission Reduction Targets may additionally support Ukraine's role in electricity exports in the future. It is believed that participation in the Energy Community facilitates the achievement of both the abovementioned goals.

Ukraine's Obligations Arising from Participation in the Energy Community

According to Article 1 of Ukraine's Accession Protocol, the country is "subject to all obligations imposed by the Treaty and by all Decisions and Procedural Acts adopted in application of the Treaty since its entry into force".⁹ Article 2 of the document identifies the relevant sections of the *acquis communautaire* in the fields of gas¹⁰ and electricity¹¹ markets, environment¹² and renewables,¹³ which Ukraine took upon itself to implement as a member of the Energy Community. The Accession Protocol introduced a tight timetable for implementation of these obligations. It is noteworthy that the governmental Action Plan for implementing the obligations under the Energy Community Treaty was adopted on 3 August 2011, that is, 6 months after the accession.

The most urgent and the most important elements of Ukraine's obligations—the reform of the gas and electricity sectors—were to be implemented by 1 January 2012. According to the Energy Community *acquis*, both sectors should be gradually liberalised.¹⁴ This should be achieved through the creation of a regulatory authority independent of the interests of each industry; the legal and organisational unbundling; providing third party access to gas and electricity transmission and distribution systems; introducing transparent tariffs and non-discriminatory rules for access to transmission and distribution systems; and ensuring protection for vulnerable customers. As mentioned in the first chapter, Ukraine, as a member of the Energy Community, agreed to implement the third energy package by 2015.

Obligations in other fields are either less strict, or have significantly longer implementation periods. Regarding renewables, obligations consisted of the preparation, by 1 July 2011, of plans for the implementation of two directives, aimed at creating favourable conditions for selling electricity generated from renewable sources and supporting the use of renewable fuels in transportation. In the environment sector, only one directive,

⁹ *Protocol Concerning the Accession of Ukraine to the treaty Establishing the Energy Community*, 27 September 2010, www.energy-community.org.

¹⁰ *Directive 2003/55/EC concerning common rules for the internal market in natural gas; Regulation 1775/2005 on conditions for access to the natural gas transmission networks; Directive 2004/67/EC concerning measures to safeguard security of natural gas supply.*

¹¹ *Directive 2003/54/EC concerning common rules for the internal market in electricity; Regulation 1228/2003 on conditions for access to the network for cross-border exchanges in electricity; Commission Decision 2006/770/EC amending the Annex to Regulation 1228/2003 on conditions for access to the network for cross-border exchanges of electricity; Directive 2005/89/EC concerning measures to safeguard security of electricity supply and infrastructure investment.*

¹² *Directive 85/337/EEC on the assessment of the effects of certain public and private projects on the environment; Directive 1999/32/EC relating to a reduction in the sulphur content of certain liquid fuels; Directive 2001/80/EC on the limitation of emissions of certain pollutants into the air from large combustion plants; Directive 79/409/EEC on the conservation of wild birds.*

¹³ *Plan for the implementation of Directive 2001/77/EC on the promotion of electricity produced from renewable energy sources in the internal electricity market; Plan for the implementation of Directive 2003/30/EC on the promotion of the use of biofuels or other renewable fuels for transport.*

¹⁴ Liberalisation of the natural gas market should take place in two stages: from 1 January 2012 for non-domestic customers, and from 1 January 2015 for all customers.

regulating the level of sulphur in liquid fuels, was to be implemented by the beginning of 2012. The rest of the environmental *acquis* allows much more time for implementation (the Environmental Impact Assessment Directive is planned to be implemented by 1 January 2013, the Wild Birds Directive by 1 January 2015, and the Directive on the limitations of certain pollutants into the air from large combustion plants by 1 January 2018). It is worth noting that the government decided to go beyond the provisions of the Accession Protocol and implement, by 1 February 2012, two directives on energy efficiency.¹⁵ These documents provide the basis for increasing the efficiency of the end use of energy and improving the level of energy performance of buildings.

The First Year's Achievements

The abovementioned obligations generally correspond with Ukraine's internal Energy Strategy, adopted by the government in 2006 for a period until 2030, which anticipates the adaptation of adequate EU legislation as well as integration of energy networks and unification of standards. Taking into account the terms of implementation of some significant obligations under the Accession Protocol, it is worth summarising Ukraine's achievements during the first year of membership of the Energy Community.

Ukraine has taken some steps towards establishing an independent regulator of the energy sector. Until November 2011, the gas and electricity sectors were both regulated by the National Electricity Regulatory Commission of Ukraine. In November 2011, President Yanukovich signed a decree creating the National Commission on Energy Regulation of Ukraine (NERC), which is to take on the role of national energy regulator. However, there is still no relevant law regulating the functioning of this institution. One of the main challenges in this field is greater independence of the regulator, which is in practice subordinate to the executive. As a result, doubts may arise regarding its independence from the interests of the gas and electricity industries.

Since 2010, Ukraine's overall legal framework in the gas sector has been consistent with the Energy Community *acquis*. Some details of the law on the functioning of the gas market should be regarded as shortcomings, and in need further improvement.¹⁶ Generally, the progress in the field of Ukraine's gas market liberalisation could be achieved mainly through adoption of a set of secondary legislation, in order to facilitate the introduction of the abovementioned detailed obligations. By the end of 2011, the Ukrainian authorities had not introduced any legislation changing the existing 'rules of the game' of the internal gas market. In February and March 2012, NERC started preparing regulations for setting the status of "eligible customers" (i.e. those free to purchase gas from the supplier of their choice), but these regulations have not yet been introduced. Although the Ukrainian

¹⁵ *Directive 2006/32/EC on energy end-use efficiency and energy services; Directive 2010/31/EU of the European Parliament and of the Council on the energy performance of buildings.*

¹⁶ "Zakon pro rynek gazu v Ukraïni: chy vidpovidaye vin yevropeyskym pravylam," *Ukrayinska Energetyka*, 16 July 2012, www.ua-energy.org.

authorities announced the restructuring of Naftogaz in order to provide better transparency on the market, and prepare the ground for further market reforms in accordance with the third energy package, no significant steps were taken in this direction in 2011. In April 2012, the parliament changed the law on pipeline transport, providing the government with the right to reorganise Naftogaz in order to fulfil obligations under the Energy Community Treaty. The restructuring itself has not started yet. The final model of reform will probably be defined by the outcome of Ukraine's negotiations with Russia on gas prices.

Unlike in the gas sector, the fundamental act regulating the principles of the functioning of the electricity market, which would bring the overall legal framework of the electricity sector closer to the Energy Community *acquis*, remains in the phase of preparation. The goal of electricity market liberalisation thus remains even further from realisation than in the case of the gas sector. The Ukrainian authorities took some steps aimed at reforming the electricity market in 2011. In particular, the process of privatisation in the sector was intensified, resulting in the privatisation of seven energy companies in the 2011.¹⁷ However, due to the lack of an adequate legal framework regulating the basic principles of the functioning of the market, this process did not result in greater competition. In practice, it has led to the domination of the sector by one holding – DTEC,¹⁸ controlled by Rinat Akhmetov¹⁹. Probably the main reason for privatisation in the electricity sector is the fact that the state does not have enough resources to invest in the necessary modernisation of the generation, transmission and distribution infrastructure.

An unequivocal assessment of achievements in the spheres of environment, renewables and energy efficiency is hardly possible, due to much longer implementation periods. There were only superficial changes to the legislation aimed directly at the implementation of the adequate Energy Community *acquis* in 2011. At the same time, it is necessary to indicate both positive and negative tendencies in the functioning of these spheres in accordance with Ukraine's international obligations. On the one hand, according to the Energy Community's Annual Report,²⁰ Ukraine has prepared action plans on implementation of directives on renewables. Nevertheless, neither document has been published by the Ukrainian government. Significant investments in the sector of renewables resulted in the opening of wind and solar power plants in 2011. These investments were predominantly driven by already existing legal provisions. In particular, "green tariffs" for electricity generated with the usage of 'green technologies' were introduced in 2008. In 2011, the law on state guarantees to promote the use of renewable energy sources was

¹⁷ Vladimir Krivitskiy, "Mezhdunarodnyy aspekt privatizatsii otechestvennoy energetiki," *Zerkalo nedeli*, 11 November 2011.

¹⁸ Yuriy Vinnichuk, "Dominuvannya Rinata Akhmetova: eneretyka," *Ekonomichna pravda*, 24 January 2012, www.epravda.com.ua.

¹⁹ Rinat Akhmetov is a Ukrainian businessman, politically affiliated with the ruling Party of Regions. He is considered to be the richest Ukrainian.

²⁰ *Annual Report on the Implementation of the Acquis under the Treaty Establishing the Energy Community*, 7 October 2011, www.energy-community.org.

adopted. On the other hand, the Ukrainian government has not managed to fine-tune the necessary technical regulations on decreasing the amount of sulphur in liquid fuels in accordance with the Directive on sulphur in liquid fuels. Some serious doubts have been raised concerning Ukraine's ability to implement the EU's environmental directives in accordance with current deadlines. In particular, a number of Ukraine's biggest energy companies have underlined the need to postpone implementation of the Directive on the limitations of certain pollutants from large combustion plants until 2028 – 2030²¹ (instead of 2018, as initially planned). Not much progress has been achieved in the sphere of energy efficiency. In particular, the National Action Plan on Energy Efficiency has not been prepared in accordance with the government's schedule. Some draft legislation on energy audit, energy efficiency, energy balance and regulation in the sphere of energy efficiency has been drawn up, but have not been yet adopted by parliament.

The Lessons Learned

Neither of Ukraine's abovementioned short-term goals motivating it to join the Energy Community were achieved during the first year of membership of the organisation. In January 2012, the EU expressed its will to serve as a liaison in Ukrainian-Russian negotiations on gas prices.²² This readiness, however, is not based directly on political or legal mechanisms established by the Energy Community Treaty. At the same time, the EU has not started any programme supporting the modernisation of Ukraine's GTS. It remains conditional on the progress in gas market liberalisation. As a result, the most important lesson of Ukraine's first year of membership of the Energy Community can be expressed as a lack of a mutually accepted strategic vision of goals that could be achieved through joint efforts.

The abovementioned misunderstanding dominated the energy dialogue between Ukraine and the EU, caused mutual disappointment, and distracted attention from the need to look for viable solutions to problems of greater strategic importance for both sides. At least two such problems should be underlined here. Firstly, participation in the Energy Community has not become a stimulus for any significant steps that would evidence the Ukrainian authorities' readiness to reform and modernise the country's energy sector. The progress of implementation of the Energy Community *acquis* cannot be regarded as systematic, as most of the obligations under the Accession Protocol have not been fulfilled according to the timetable agreed. Most importantly, despite initial declarations and obligations, not much has been done in terms of reforming the Ukrainian gas and electricity sectors in order to bring them closer to the principles of the free market. Secondly, the experience has shown that Ukraine's local specificity, in particular the enormous costs of the

²¹ "Predstavnyky NAK "Energetychna Kompaniya Ukrayiny" podilylysva svoyim bachennyam shchodo gaarmonizaciyi ukrayinskogo zakonodavstva iz Zakonodavstvom ES," website of the National Joint Stock Company "Energy Company of Ukraine", 10 March 2011, www.ecu.gov.ua.

²² "EU ready for role in Kiev gas discussions," *United Press International*, 16 January 2012, www.upi.com.

country's compliance with the Energy Community *acquis*, has not been taken fully into account. Ukraine's aspiration for obtaining guarantees of financial support in return for accepting the Community's 'rules of the game' are not groundless. Furthermore, both of the problems mentioned have shown the volatility and uncertainty of the country's proclaimed goal of European integration in general. From this perspective, the experience of dealing with the Ukrainian authorities implementing the Energy Community *acquis* is of great value from the point of view of preparing for further integration processes, in particular the implementation of the Association Agreement and creation of a Deep and Comprehensive Free Trade Area, which is currently in abeyance due to increasing instances of the Ukrainian authorities disregarding respect for democratic values.

It is hard to predict possible scenarios regarding Ukraine's further activity as a member of the Energy Community. The abovementioned Ukrainian-Russian gas negotiations, as well as the Ukrainian government's dispute with the Energy Community Secretariat, have proved that Ukraine does not exclude the possibility of denouncing the Treaty if satisfactory conditions regarding gas prices can be obtained from Russia. Should this happen, the EU's neighbourhood policy will suffer its biggest failure so far. In order to maintain the momentum of Ukraine's integration with the EU in the energy field, a review of the timetable for implementation of the Energy Community *acquis*, as well as financial and technical support for the process, seem to be unavoidable. Additional financial support could undoubtedly induce the Ukrainian authorities to reform the energy sector in accordance with the EU's energy market principles. It should be preceded by an independent assessment of the investment requirements of Ukraine's energy sector. Taking into account the uncertainty of the sector's future development, any additional support should rather be provided in the form of credits and be coupled with an objective and thorough system of monitoring. This goal can be achieved by creating a consortium of independent think-tanks equipped with sufficient access to information.