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Oil, Gas & Energy Law Intelligence

Energy Community - What Does it Mean for Ukraine? by E. Rybak

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Energy Community– What Does It Mean For Ukraine?

Elena Rybak

I. Introduction

It is just over three years since Ukraine became a full member of Energy Community (EnC) with the Treaty being ratified in February 2011. What did joining the EnC mean for Ukraine? If I had to answer this question before November 21, 2013, when a handful of Ukrainians first went to the central square outraged at the governments statement of suspending the process of signing EU Association agreement just the day before the Vilnius summit... my answer would probably be very different. That answer would have been before Ukraine changed, before my nation (or the major part of it) was re-born, before we lived through a national tragedy and, for the first time in at least three generations, we started consciously understanding what do those loud words like “peace”, “freedom”, “dignity”, “unity”, and “sacrifice” mean. That was before millions of Ukrainians all over the world peacefully protested against the corrupt government for months, while being patiently ignored and intimidated. Before all the leading newspapers’ headlines continuously communicated the “deepest concerns” from all the global leaders. Before the first victims died in central Kyiv, including Armenian, Belorussian and Georgian fighters. Before Ukraine learned the hard way that it does have friends and global support, but the process needs to start from the inside, fighting for our rights and freedoms and for a more united and independent Ukraine; and perhaps then we will be in a position to positively utilize the help coming from external sources.

Even though the internal Ukrainian conflict is not over yet, these past few months have delivered a valuable lesson, not only to Ukraine, but to the Western world as a whole. Following the reaction of Russia to increase gas prices, energy security climbed up the list of national and international priorities to the top. The endless fight for energy resources might be solely a geopolitical game or a much deeper battle of two very different visions of civilizations. The Energy Community, though a relatively “young” institution, already has a say in this geopolitical debate, which may well be increasing in the years to come.

It hurts to understand how much time Ukraine lost in reforms implementation during the past decade (if not all 23 years of independence), and particularly the past three years when the help from EnC was already available. Was it entirely the fault of Ukraine in underperforming or was it also a drawback of the Energy Community Treaty lacking the enforcement mechanism for countries to stick to their commitments? This would be one of the aspects I would like to discuss further.

Finally, it is clear and well known that the cheapest energy is the energy we save. Energy efficiency for Ukraine has to be the priority number One. An immediate consequence of energy efficiency measures would be the enormous impact on energy independence and energy security of Ukraine, which would be achieved by merely reaching basic energy saving and modernization targets (i.e. in district heating systems where the energy saving potential is 30-50%; in buildings – 40-70%, etc.). It is a matter of long term programs and investment availability, but it is also a matter of changing the mentality and switching to long term sustainable thinking, which Ukraine is unfortunately still lacking. I think this could continue to be one of the key roles of EnC – bringing the best models and experience while developing tangible tools to encourage and monitor the accomplishments of countries achieving the set targets.

II. Performing under the Energy Community Treaty: where does Ukraine stand? OPTION 2: Reforming the Ukrainian energy sector: status quo.

"Energy Community is about investments, economic development, security of energy supply and social stability; but - more than this - the Energy Community is also about solidarity, mutual trust and peace." – European Commission.

Some civilizations have been luckier than others in finding themselves sitting on natural resources like oil, gas, or rich and productive soils. Deprived nations historically have shown different success rates in exploring their hidden reserves or simply chose to focus on other aspects of economic growth. Ukraine in its turn is coming from what some like to call “accidental freedom” from Soviet Union, when geopolitical reforms preceded the consciousness, mentality and acknowledgement of value of what happened to become a New Independent State. While our Western neighbors during the past 20 years faced all the coming challenges and focused on rebuilding their countries with some examples of amazing success stories, Ukraine continued to live a thoughtless life increasing the gap between those who became “rich overnight”, forming new political elites with old faces, and those who continued their every day survival with hard work and hopes for a better life.

Energy resources were never a thing of value. This was a common ‘good’ available to everyone in the needed amounts from the almighty communist era. Times changed. Generations changed. The new generation growing up in the independent Ukraine started showing more signs of striving to absorb the European values and pursue the better standards of living. Could Russia allow that to happen? – this will be a question for historians for upcoming decades. An on-going dialogue with the EU and eventually joining the Energy Community was gradually sparking conflicts with our “older-brother-Russia” while continuously changing Ukrainian governments started to be more weary of Ukraine losing its role of gas

transit country, which would ultimately result in abnormally high gas prices, and damaging the Ukrainian economy creating a social burden for many generations to come.

“Today’s signature {of the Treaty} signals our political intention to re-build the principles of Ukrainian energy policy with the EU” – said at that time Minister of Energy of Ukraine Yuri Boyko¹. This is how it started, but it did not take even a year for the same Minister Boyko to express his dissatisfaction with the Energy Community. In doing so, he underlined two reasons for Ukraine joining the EnC: financial support in modernizing the gas transport system of Ukraine and the issue of the South Stream project, which was against Ukraine’s national interests².

Somehow Ukraine missed on what the Energy Community was really about: security of energy supply, mutual trust and peace. National interests versus regional geopolitical interests are a difficult topic, but the Ukrainian citizen I am tends to feel that we were driven by the wrong motivations. Over the years Ukraine struggled in delivering the bare minimum required through its international commitment to get this process moving. We approved the Law on the “Principles of functioning of the gas market”, we drafted the law which would help us liberalize the electricity market. We put check marks in deliverables and continuously failed in implementation. This in turn is “natural”, but sad, since implementation requires much more effort, many more secondary legislations, and this would also mean making the first steps in establishing transparent mechanisms on the energy market, which was far from the individual corrupt interests of some officials.

In 2014 Ukraine holds the Presidency of the Energy Community, which started already during the times of high political crisis on the peak of revolution in Ukraine. At the signing ceremony of a Memorandum of Understanding on “Establishing an Implementation Partnership between the Ministry of Energy and Coal Industry of Ukraine and the Secretariat of the Energy Community”, the Director of the Energy Community Secretariat, Janez Kopač, mentioned the “valuable progress” that Ukraine made in meeting its international obligations under the ECT³. There are many analytical reports on Ukraine’s accomplishments of international energy-related obligations (inter alia “Eight joint EU-Ukraine report on energy cooperation”⁴, the Monitoring of Ukraine’s implementation of EnC commitments⁵, or the annual publication “Third year in EnC”⁶), but I would like to elaborate on a few of these.

¹ http://www.bbc.co.uk/ukrainian/news/2010/09/100924_ukraine_eu_energy_az.shtml

² <http://ua-energy.org/post/16099>

³ <http://www.energypost.eu/ukraine-turns-eu-energy/>

⁴ http://ec.europa.eu/energy/international/bilateral_cooperation/doc/ukraine/20140320_mou_progress_report8_en.pdf

⁵ http://ua-energy.org/upload/files/EnC_newsletter1_2014_ENG.pdf

⁶ http://ua-energy.org/upload/files/Web_final_Dixi_EnC3_ukr_2014.pdf

Ukraine has made quite significant progress in preparation of framework laws in the *gas sector*, just enough to fulfill the initial EnCT requirements, but is lagging behind in practical steps to separate the vertically integrated companies which would allow for independent operation of production and transportation companies. The non-linear and regularly changing political strategy regarding the gas market does not yet allow to foresee clearly where Ukraine is heading, and at what speed. The implementation of the Third Energy Package, as well as the projects of “joint interest”, will play an important role in the upcoming discussions with the EU and the Energy Community Secretariat.

The reform of the *electricity market* remains challenging. A key milestone – the Law on “Electricity market regulations” – was approved as the first step to set basis for liberalizing electricity market and move away from the “whole sale electricity market”. Yet, during the preparation of the law, a number of comments from international organizations were not considered. Among them: Ukraine still has to work on the issues of the remaining subsidies within the sector, ensure market based tariff setting, establish clear timeline and action plan on implementation of bilateral consumer contracts and separation of supply and distribution companies. Additionally, the more detailed grid access regulations and procurement rules remain a work-in-slow-progress.

The reform of the electricity market will also, in the midterm, influence the *renewable energy* market and the green tariff for electricity generated by renewables. Until then, Ukraine has already developed (but not yet approved as of April 2014) the National Renewable Energy Action Plan. Whereas the diversification of energy resources is on the top of the agenda, in line with the energy independence target, Ukraine under the EnCT is obliged to set the national target at 11% of the renewable energy share in the final consumption as well as 10% share in the transport sector, by 2020. At the same time draft of an updated Energy Strategy to 2030 – after a long stakeholders’ discussion between 2011 and 2013 - could only agree on a 10% target. To the surprise of most of the market players a share of “12,6% in total balance of installed capacities until 2030” was eventually set in the document published in January 2014. Whatever the target, generating 8 GW of renewable energy is an ambitious yet quite questionable level to reach, given that current share of renewable energy is about 2% of total installed capacities (approx. 0,9 GW as of June 2013)⁷. There are surely questions to the document, including alignment of time frames and generation vs. installed capacity calculation, which seems to be also clear to the current government officials. According to the decision of the National Security and Defense Council of Ukraine, published in May 2014 they have to “actualize the articles of Energy Strategy of Ukraine until 2030, with the goal to secure implementation of international commitments of Ukraine in regards to the development of renewable energy sources, taking into consideration the energy security

⁷ <http://imepower.files.wordpress.com/2013/10/ukraine-renewable-energy-newsletter-27.pdf>

threat in connection to the temporary annexation of the territory of Autonomous Republic of Crimea”⁸. Among other challenges in achieving this goal are the difficult grid access rules (and in general the grid capacities for renewable energy), as well as the local content requirement for the green tariff, which for some sources of renewable energy was set up to 50% in the technology ratio⁹.

The progress made with implementing the *energy efficiency* obligations is probably the worst. Despite Ukraine making progress with several energy labeling regulations, the National Energy Efficiency Action Plan (NEEAP), developed in 2012 but not yet approved by the government, is becoming outdated without even entering into force. Other EnC Members are already working on their 3rd NEEAPs and Ukraine’s target of decreasing energy consumption by 9% by 2020 becomes less and less realistic, as time is running. In early 2014 the European-Ukrainian Energy Agency completed a NEEAP Assessment in the form of survey among market experts.¹⁰ The main conclusion reached is that the document in general was quite detailed and ambitious, delivering a broad list of “what” has to be done, while very limited understanding of “how” that would be done. The main challenge of course is financing the estimated billions of dollars of investments, which the Ukrainian government all the time declares to be “brought” from other sources, whereas the investment climate and attractiveness is rather sad. Even with the hundreds of millions Euro yearly committed by IFIs and donors there is no way to have sufficient funds without developing private public partnerships, ESCO mechanisms, energy performance contracting and attracting private investors with various other economic incentives.

It is hard to accept that energy saving – what should have been the Number One priority of the government, historically dependent on imported energy resources, has been neglected so long. The country on the verge of infrastructural collapse, with every annual heating season bringing more and more accidents, leaving people without electricity or heat in their homes at -20C outside temperature, has barely done anything to speed up progress in implementing reforms. Wasting billions of Ukrainian Hryvnias every year coping with the damages, maintenance and covering for network losses is the peak of carelessness by different officials over the past decades. The support from donors with demonstration projects, in developing laws and regulations and promoting energy efficiency among consumers, has only brought very limited tangible results, simply because of the reluctance with which the government has pursued energy saving and sustainable development principles. The draft laws developed in frames of technical assistance programmes are for years pending approval and suffering from bureaucracy. Market based energy prices would mean decrease in political ratings, hence never

⁸ <http://www.rnbo.gov.ua/documents/346.html>

⁹ At the time this article is being written the Ukrainian government is discussing the amendments to the law , which would decrease the local content requirement to 30%, which in some projects is still challenging because of the underdeveloped local market of competitive technologies.

¹⁰ http://euea-energyagency.org/images/articles/events/Booklet_EUEA_Final.pdf

allowed apart from when absolutely necessary (i.e. to receive a tranche of IMF loan). To be able to save energy Ukrainians would need to install heat and water consumption devices, develop energy monitoring and energy management systems – but this would make the energy sector already much more transparent than some officials could allow, otherwise their private profits would dramatically drop. Some excellent demonstration projects and initiatives have been carried out at the local levels with the donor support (incl. modernization of public buildings, education seminars in schools and universities, public awareness raising campaigns etc.), but Ukraine is a large country and it takes time to spread the word about the best practices, even longer to copy these best practices in other neighbouring cities.

Are all the efforts useless? Quite the contrary, Ukraine's international commitments, including those under the EnC have been crucial in providing NGOs and other market stakeholders with the tools to press various governmental institutions with gentle (and sometimes quite direct) reminders that such a slow progress is unacceptable. Over the past years our list of arguments was strongly supported by a long list of EU directives and internal requirements, by political dialogue with the EU and by the examples of other EnC countries (both positive and negative). If it was not for the active and constant presence of the Energy Community representatives and numerous donors in the country we would not be where we are. But where is Ukraine, then, considering all the above? Seems just waiting. There are number of developed tools and mechanisms, there is needed experience on the ground, readily available support from our international partners, with the network and competences within the Energy Community to make a step towards the path of reforms. The main bottleneck over the years was the lack of political will and corruption. Today Ukraine, with the support of our neighboring Russia, has come to realize that such behaviour is no longer acceptable. The time to act has never been so right. The diplomatic patience of the EU will hopefully be proven worthwhile, and Ukraine will start delivering on the so much needed actions. Finalizing the draft laws and speeding up on secondary legislation is a pre-requisite for any reform and a good way to start.

In all the sectors of the economy energy plays a crucial role. Energy costs money and can no longer be taken for granted. Ukraine is learning this the hard way, but the lesson will last. All ambitious targets (i.e. full and fast liberalization of gas and electricity market; decreasing energy consumption by 9% by 2020; generating enough energy from renewable sources to meet EnC requirements) might not be achieved, but their existence is already relevant and creates pressure. So far the progress is limited and could be much, much more; but as rightly noted by Mr. Kopač – “valuable”, because otherwise there would be no progress at all. Without the institutions like the Energy Community the local players (civil society, business, donors, policy makers, think tanks, media, etc.) would never be able to simply “encourage” the local government to make the right choices.

III. Outlook

Regional initiatives and organizations, like EnC are important, both to reach set regional objectives, as well as to give examples of joint effort, coordination and mutual support for the benefit of larger group of stakeholders. There are several important considerations to be made for the years to come, which might positively influence the initial purpose of EnC creation and the member countries.

- A) Covering the gap between obligations taken and the required actions by the Contracting Parties for further implementation. There have to be more mechanisms to oblige the countries to deliver, which will in turn help the EnC as an international organization to avoid situational behaviors of the member countries (i.e. changing our mind every time Russia promises a discount on gas). Prior to setting these “mechanisms” one has to answer question - what is it that makes EnC attractive? What are the motivations for the Contracting Parties to sign the Treaty? For each country the reasons might vary, but this would be exactly the leverage that can be used to occasionally insist that some Members speed up with performance. As Energy Community expands in its influence, the demand for being a member also grows. Each Contracting Party needs to be aware that as much of “voluntary” decision they can make to join, once that is done, they have to perform.

In perspective, most successful countries might receive a bonus in a form of more support to their priority projects. This could encourage better performance, whilst the opposite could negatively influence or temporary delay the on-going projects and initiatives.

- B) Encouraging countries to distinguish between pure modernization of infrastructures versus making it more energy efficient and sustainable is another important aspect to tackle the energy dependence of some member states. The time horizon in countries like Ukraine is short term, which for important infrastructure projects is simply not long enough. In Ukraine, the lack of investment resource and constant focus on “immediate” problems prevent the thoughtful and strategic planning during the project development. For example, in district heating companies, decision makers still prefer to i.e. invest EUR 100 thousand into the new boiler, which will save 5-10% of gas and pay back in 2-4 years. An alternative scenario would be to take a district, which would allow to install an individual heating substation on each building (for the purpose of calculation, let us say 40 buildings), replace some 3-5 km of heating network (change to pre-insulated pipes and switch from 4-pipe-old system to 2-pipe system). Given that only these measure allow to save 30-40% of energy the company would need boiler(s) of smaller capacity and many in the area could even be closed. Such project can cost between EUR 5-10 million and would normally be paid back within 4-7 years. Assuming that rehabilitation of

apartment buildings is also carried out (with estimated energy saving potential 40-70%), the impact on the environment and social aspect is enormous, and the investment into the “new heat generation” capacities would be much more efficient while new boilers will not continuously “heat the air”. Ukraine is a large country and it is simply impossible to do everything at once. Though, the importance of proper planning to decrease the consumption first, and split the task into smaller achievable goals, should not be underestimated.

- C) Finally, the Energy Community has a crucial role to play in making energy reforms compatible with social expectations and public perception. Ukraine is one of those countries in which public perception about energy resources in general is still very old-fashioned and “sovietized”. This may be natural for the post soviet union generations, but matching the real situations with the public understanding and developing acceptance will remain one of the key challenges for us in the coming years. Population needs to be educated about how to use energy, why do local markets need reforms, what will it mean for their daily lives, what kind of impact the international obligations and local regulations have on their monthly energy bills. With the deeper understanding of how the energy markets function and why do energy prices increase, people have to learn how to demand the tools to save energy. Lack of this knowledge in Ukraine is causing public protest against the increase in energy tariffs and is limiting acceptance of other aspects that positively influence all of our lives (like improved environmental and living conditions). Ideally, people should be the driving force to pursue energy saving and demand required regulations from politicians to allow them to save. Consequently, the Energy Community should focus on encouraging and supporting the dialogue between government, civil society and business. The Secretariat has been taking needed steps in this direction, from what I could personally witness in Ukraine.

IV. Conclusions

Regional initiative, which supports energy reforms for energy security is timely and essential in today’s geopolitical situation. The size and flexibility of institutions, like Energy Community, allows to provide required support to the member countries, while avoiding some of the bureaucratic and time consuming processes. Contracting Parties have a unique chance to absorb best practices and learn from mistakes already made in history.

The pre-requisite for achieving objectives of Energy Community Treaty - is performance of the undertaken commitments by each of the member states. Whilst the nature of the membership is voluntary it has to be clear for those joining, that once the step is made they have to meet the

expectations. On-going dialogue, adjusting bilateral targets and clear Action Plans are crucial to move forward in reaching the single joint objective – “promoting investments, economic development, security of energy supply and social stability”.

Increasing public awareness and encouraging the “bottom up” approach to push reforms will allow local communities and regional authorities within the countries to have more flexibility to implement regulations needed to attract investments on local level. By increasing the activity on local levels in some countries (i.e. Ukraine) it will be easier to push changes on the national scale. Close cooperation between the international organizations (including international finance institutions and donors) with business, civil society, and media will positively contribute to the sustainable development of each Contracting Party and the region, ensuring the Energy Community reaches its most important goal – “solidarity, mutual trust and peace”.

May 11, 2014

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Note: this article represents solely an opinion of the author and is not an official position of any organization.