

Opinion 1/20

pursuant to Article 3(1) of Regulation (EC) No 714/2009 and Article 10(6) of Directive 2009/72/EC – Ukraine – Certification of *Ukrenergo*

On 7 October 2019, the National Commission for State Regulation of Energy and Public Utilities of Ukraine (hereinafter “NEURC”) notified the Energy Community Secretariat (hereinafter “the Secretariat”) of a preliminary decision (hereinafter “the Preliminary Decision”) on the certification of the Joint Stock Company National Power Company *Ukrenergo* (hereinafter “*Ukrenergo*”), the transmission system operator for electricity (hereinafter, “TSO”). The Preliminary Decision was adopted on 7 October 2019 and based on Articles 31-34 of the Law on electricity market of 2017 (hereinafter: “the Electricity Market Law”).¹

Pursuant to Article 10 of Directive 2009/72/EC² (hereinafter, “the Electricity Directive”) and Article 3 of Regulation (EC) No 714/2009³ (hereinafter, “the Electricity Regulation”) the Secretariat shall examine the notified Preliminary Decision and deliver its Opinion to NEURC as to the compatibility of such a decision with Article 10(2) and Article 9 of the Electricity Directive.

I. Background

1. The applicant *Ukrenergo*

Ukrenergo holds a license for transmission of electricity issued by NEURC⁴ and operates the electricity transmission network in Ukraine. It also performs central dispatching, balancing and allocation of the interconnection capacities at the borders. The transmission system operates in a synchronous mode with the Unified Power System (UPS) of the Russian Federation, Belarus and Moldova except for the so-called “Burshtin Island”, which is interconnected and synchronised with the ENTSO-E network.

Ukrenergo was created as a state enterprise in 1997⁵ as a successor of the two state enterprises National Dispatch Centre of Ukraine and State Electric Company *Ukrelektroperedacha*. It succeeded in all rights and obligations of those two companies.

According to Article 31 of the Electricity Market Law of 2017, the state enterprise *Ukrenergo* had to be corporatized, i.e transformed into a joint stock company, all shares in which are owned by the State which is and not subject to privatization. Based on point 16 of the Final and Transitional Provisions of the Electricity Market Law, *Ukrenergo* was first transferred from the Ministry of Energy and Environmental Protection to the Ministry of Finance.⁶ The State ownership in *Ukrenergo* is henceforth represented by the Ministry of Finance. In February 2019, the Ministry of Finance

¹ Law of Ukraine No.2019: ‘On electricity market’, adopted on 13.04.2017 by Verkhovna Rada. The Law was signed by the President on 08.06.2017 and was published in Official Journal on 10.06.2017. The Law entered into force on 11.06.2017.

² Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC, as incorporated and adapted by Decision 2011/02/MC-EnC of the Ministerial Council of the Energy Community of 06.10.2011.

³ Regulation (EC) No 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003, as incorporated and adapted by Decision 2011/02/MC-EnC of the Ministerial Council of the Energy Community of 06.10.2011.

⁴ NEURC Resolution No. 1366 of 28.10.1998 further reissued by NEURC Resolution No. 1012 of 17.07.2014.

⁵ Ministry of Energy Order No. 54 of 15.04.1998.

⁶ Resolution of the Cabinet of Ministers No.1001-p of 14.11.2018.

approved a new statute of *Ukrenergo*.⁷ By Order of the Ministry of Finance of 29 July 2019,⁸ *Ukrenergo* was transformed into a private joint stock company. The Ministry of Finance is the sole shareholder of *Ukrenergo*.

As a joint stock company, *Ukrenergo* has the following corporate bodies: shareholder's assembly, supervisory board and management board. The rights and obligations of the shareholder assembly are exercised by the Ministry of Finance pursuant to the Law on Joint Stock Companies, and the Law on Management of Objects of State-Owned Property. The supervisory board controls and supervises the operation of the management board. Its members are appointed by the shareholder assembly, i.e. by the Ministry of Finance. The current supervisory board decides with simple majority of its members. The supervisory board was appointed by the Ministry of Finance on 29 July 2019.⁹ The management board manages the company and adopts the financial plan. The management board is composed of minimum three and maximum five members appointed by the supervisory board. The supervisory board appointed the members of the management board, including the acting chairman and the two deputies.¹⁰

According to Article 116(5) of the Constitution, State property is managed by the Cabinet of Ministers. In 2017, the Cabinet of Ministers¹¹ had decided that the transmission assets which had been on the balance sheet of the state enterprise are transferred to the joint stock company *Ukrenergo*, including the so-called economic management right over the transmission assets to *Ukrenergo*. Already before corporatization, *Ukrenergo* had managed the transmission assets on the basis of that title. The Commercial Code of Ukraine provides that the State can exercise its right of State ownership in the public sector through other bodies based on the right of economic management over state-owned assets. The nature and scope of economic management rights are defined in the Commercial Code of Ukraine. The economic management right is defined in the Commercial Code as a "*material right of economic entity owning, using and disposing of property assigned to it by the owner (authorized body) with some restriction of management of certain types of property on the agreement of the owner in cases provisioned by this code and other laws.*"¹² Both the Commercial Code¹³ and the Electricity Market Law¹⁴ prohibit *Ukrenergo* to give "*into concession, lease, economic management, to the authorized capital of other legal entities, except where such transfer is made to the authorized body for management of state property objects or to the economic entity the corporate rights in the authorized capital of which are owned solely by the state.*"

2. State activities in generation and supply of electricity and natural gas

The Preliminary Decision explains that public authorities such as the Cabinet of Ministers of Ukraine, the Ministry of Energy and Environmental protection, the Ministry of Agrarian Policy and Food of Ukraine, the Ministry of Infrastructure of Ukraine and the State Property Fund of Ukraine have under

⁷ Ministry of Finance Resolution No. 72 of 15.02.2019.

⁸ Ministry of Finance, Order No. 321 of 29.07.2019.

⁹ Ministry of Finance of Ukraine, Order on some Issues of Establishment of a Private Joint Stock Company National Power Company *Ukrenergo*, No. 321 of 29.07.2019, appointing the Supervisory Board of JSC NPC *Ukrenergo*.

¹⁰ Minutes of the meeting, Resolution of the Supervisory Board of *Ukrenergo* No. 7/2019 of 29.08.2019.

¹¹ Decree of the Cabinet of Ministers of Ukraine No. 829-r of 22.11.2017.

¹² Article 136 Commercial Code, No.436 of 16.01.2003.

¹³ Article 75(5) Commercial Code reads: "*The State commercial enterprise has no right to transfer the proper property to other legal entities or citizens, except for the cases stipulated by law. To alienate property objects belonging to fixed assets, the State commercial enterprise has the right only with the prior consent of the body whose sphere of management it belongs to, and only on a competitive basis, unless otherwise established by law*"

¹⁴ See: Law No. 264-IX, 31.10.2019

their governance business entities engaged in the activities of generation (production) and/or supply of electricity (natural gas). Most notably, the Cabinet of Ministers represents State ownership in *Naftogaz* (the vertically integrated gas company), *Ukrzaliznytsia* (the Ukrainian railways company supplying electricity via subsidiary), and *Ukroboronprom* (the State-owned defence conglomerate, which also is engaged in the supply of electricity via subsidiaries). The Ministry of Energy and Environmental Protection exercises shareholding rights over the state-owned electricity generators *Energoatom* (nuclear power), *Ukrhydroenergo* (hydro power), *Kaluska* (TPP) as well as several other undertakings engaged in production and supply of electricity and gas. The Preliminary Decision also notes that the Ministry of Finance is not engaged in activities or controls companies active in the production and supply of electricity or natural gas.¹⁵

On 31 October 2019, the Verkhovna Rada adopted the Law on Amendments to Certain Laws of Ukraine in Relation to Separation of Natural Gas Transportation Activities (hereinafter “the Law on Unbundling”).¹⁶ That Law entered into force after the Preliminary Decision was adopted. It amended the Commercial Code by clarifying the economic management right of transmission assets, and the Electricity Market Law by introducing a prohibition of privatization of transmission assets by the TSO.

II. The Preliminary Decision

The Electricity Market Law transposes the requirements for unbundling and certification of the TSO in Section V, Articles 32, 34-36. Only the ownership unbundling model has been transposed. Article 32 of the Electricity Market Law corresponds to Article 9 of the Electricity Directive.

On 14 August 2019, *Ukrenergo* submitted an application for certification under the ownership unbundling model to NEURC. On 7 October 2019, NEURC adopted the Preliminary Decision and notified the Secretariat.

In its Preliminary Decision, NEURC comes to the conclusion that *Ukrenergo* can be certified preliminarily, while imposing an obligation on *Ukrenergo* to amend several provisions of its statute without elaborating on the details and without imposing a deadline for such amendment. The operative part of the Preliminary Decision reads in this respect:

“To oblige PRIVATE JOINT STOCK COMPANY NATIONAL POWER COMPANY UKRENERGO, by October 20, 2019, to amend the Charter of PRIVATE JOINT STOCK COMPANY NATIONAL POWER COMPANY UKRENERGO for the purpose of excluding the provisions contradicting the requirements of the Law of Ukraine “On the Electricity Market” and other laws and regulations in the energy sphere, as regards compliance with the requirements for unbundling and independence of the transmission system operator, in particular, paragraphs 2.2.15, 2.2. 18 - 2.2.20, 2.2.24 - 2.2.27 of the Charter.”

The Preliminary Decision also stipulates that the final decision on certification would be adopted after “implementation of the required measures envisaged in the justification to the preliminary decision on certification”.

¹⁵ By contrast, the Ministry of Finance controls the national transmission system operator for natural gas, *GTSO*. It also has 22 other legal entities under its governance, and it is also managing the corporate rights of the state in three banks.

¹⁶ Law No. 264-IX, 31.10.2019.

III. Assessment of the Preliminary Decision

1. General

The unbundling provisions were designed to separate, in vertically integrated undertakings, control over transmission system operation, on the one hand, and production and supply activities, on the other hand, to eliminate a potential conflict of interest between transmission and other activities performed by vertically integrated undertakings.¹⁷ This objective is best fulfilled by implementation of the ownership unbundling model of Article 9 of the Electricity Directive, which Ukraine transposed by its Electricity Market Law. For cases, as in Ukraine, where the State as owner engages in more than one energy-related activity and is thus to be considered a vertically integrated undertaking within the meaning of European energy law,¹⁸ Article 9(6) of the Electricity Directive offers an ownership unbundling variant, an alternative to restructuring and privatization.

The Secretariat reviewed NEURC's Preliminary Decision against that background.

2. Application of the ownership unbundling provisions to *Ukrenergo*

When assessing the compliance of the Preliminary Decision with the unbundling model enshrined in the Electricity Directive, the following aspects matter in particular:

- a) The undertaking to be certified needs to be the owner of the transmission assets as required by Article 9(1)(a) of the Electricity Directive;
- b) The undertaking to be certified needs to perform the functions and tasks of a transmission system operator as required by Article 9(1)(a) of the Electricity Directive;
- c) Control over and exercising rights in the undertaking to be certified need to be separated from control over and exercising rights in undertakings involved in production or supply of electricity and natural gas as required by Article 9(1)-(3),(6),(7) and (12) of the Electricity Directive.

Compliance with Article 9(1)(a) of the Electricity Directive is a fundamental prerequisite for certification. Article 9(1)(a) of Directive 2009/72/EC requires that “*each undertaking which owns a transmission system acts as a transmission system operator*”. This means in principle that the undertaking applying for certification is the owner of the assets, i.e. the transmission system. Ownership of the transmission assets is one of the key elements of the ownership unbundling model as it ensures the uncompromised independence of the TSO in taking decisions with regard to the management and investments into the system and eliminates potential conflicts of interest with any third-party owner of the assets. Moreover, ownership of the transmission system by the TSO reduces legal and economic complexity caused by the need to establish potentially ambiguous and non-transparent contractual relations between the TSO and the owner of the assets.

¹⁷ Secretariat Opinion 1/16 of 3 February 2016 *TAP AG*; Secretariat Opinion 1/17 of 23 January 2017 *OST*; Secretariat Opinion 3/17 of 23 January 2017 *EMS*.

¹⁸ See, for instance, Commission's Opinions on certification of *Vorarlberger Übertragungsnetze (VÜN)* C(2012) 2244 final of 29.3.2012, at p. 4; on certification of *Augstsprieguma tržks* C(2012) 9108 final of 3.12.2012, at p. 2.

For the unbundling of *Ukrenergo*, this requirement is critical as compliance seems to require legislative changes. In the present Opinion, the Secretariat will focus thus on the issue of ownership (point a), without prejudice to compliance aspects related to points b) and c).

Based on Article 74 of the Commercial Code and the Order of the Cabinet of Ministers of 2017, *Ukrenergo* exercises economic management right – and not ownership – over the transmission assets.

NEURC argues in the Preliminary Decision, that based on Article 136 of the Commercial Code of Ukraine the right of *Ukrenergo* to economic management corresponds to a real right to own, use and dispose of the transferred property with the only restriction on the need to obtain the prior consent of the owner when disposing of property assigned to *Ukrenergo* under the right of economic management - the State authority, which exercises the right of ownership of the State, namely the Ministry of Finance. NEURC also noted that the right of economic management of *Ukrenergo* over the transmission system is indefinite and does not prevent them from receiving investments and credit funds.

The Secretariat cannot agree with this finding of NEURC. As the Secretariat noted in Opinion 4/19 *GTSO*, based on Article 136 of the Commercial Code, an economic management right granted by the owner establishes solely a right of usage for specified commercial purposes. The particularities of the economic activities of the State commercial enterprises are defined in Article 75 of the Commercial Code and include *inter alia*, the prohibition of the company entrusted with the economic management right to transfer its property to other legal entities or persons, except for cases as provided by laws. Similarly, the Law of Ukraine on Privatisation explicitly prohibits the privatisation of transmission system assets. This differs from other cases of unbundling in the Secretariat's practice¹⁹ where the TSO owns the transmission assets, but the TSO itself is owned by the State and a public body exercises State ownership in the company.

The Secretariat, however, notes that in exceptional cases, the European Commission in its case law on certification of TSOs accepted that where the TSO does not legally own the transmission system the rights to manage the system were provided to the TSO through a lease or concession agreement. In the Polish case, the TSO was the owner of the entire Polish transmission grid with the exception of some limited assets, which were not its property but are under its administration,²⁰ whereas in the Portuguese case,²¹ both *REN Rede Elétrica Nacional* and *REN Gasodutos* operate, respectively, the continental Portuguese electricity and gas transmission grid on the basis of concessions. In those cases the European Commission required that, in its capacity as lessee or concessionaire, the TSO's rights of use and disposal over the transmission system assets can be regarded as equivalent to those of an owner, and established criteria for assessing whether the rights are indeed equivalent to ownership. The Commission assessed whether

(i) transmission system assets feature on the balance sheets of the TSO and they can be therefore used by the TSO as a guarantee (collateral) in acquiring financing on the capital market;

¹⁹ Secretariat Opinion 1/18 of 27 February 2018 *CGES*, Secretariat Opinion 3/19 of 17 June 2019 *MEPSO*.

²⁰ Commission's Opinion on URE's draft certification decision for *PSE S.A.* of 9 April 2014 (C(2014) 2471; 093-2014-PL).

²¹ Commission's Opinion on ERSE's draft certification decision for *REN* and *RENGasodutos* of 12 May 2014 (C(2014) 3255; 094-2014-PT, 095-2014-PT);

(ii) the concessionaire is responsible for exercising all of the TSO's tasks, which include the planning, construction, operation and maintenance of the entire infrastructure and the financing thereof; and

(iii) upon the expiry of the concession, the State compensates the TSO with an amount equivalent to the corresponding value of the concession assets.²² The European Commission was thus concerned that TSOs have "*the rights of use and disposal equivalent to those of an owner*" in relation to the transmission assets.

In the case of *Ukrenergo*, while the transmission assets are listed on the balance sheet of *Ukrenergo*, the TSO is not allowed to use the assets as a guarantee for acquiring financing on the capital market. This means that already the first criteria is not fulfilled. The Law of Ukraine on Pledge explicitly prohibits pledging the State property which is banned from privatization.²³ The Commercial Code (Article 74) as well as the Electricity Market Law (Article 31, as amended) explicitly prohibit disposal and alienation of assets without consent of the authorized body, i.e. the Ministry of Finance in the case of *Ukrenergo*. This cannot be reconciled with the criteria established by the European Commission which requires the transmission system operator to be able to use transmission system assets as a guarantee (collateral) in acquiring financing for its investments. Without the TSO's right to pledge transmission system assets, the economic management right of *Ukrenergo* over the transmission assets does not fulfil the ownership requirements of Article 9(1)(a) of Directive 2009/72/EC as interpreted by the European Commission.

For the same reasons, the Secretariat does not agree with the argument that *Ukrenergo* is not prevented from raising funds and taking credits. The rationale of the European Commission's quoted above is to make sure that the TSO has effective access to the credit market, for which securities are essential. The absence of obstacles is, in itself, not sufficient to satisfy that requirement.

Consequently, the requirement of ownership of electricity transmission assets is not fulfilled, as *Ukrenergo* neither owns the transmission assets nor has rights equivalent to an owner of the transmission assets.

As NEURC noted correctly, also Ukrainian legislation, namely the Electricity Market Law, also requires that the TSO owns the transmission system, and excludes economic management right over the transmission assets. For certification in line with the Electricity Directive, however, this is not decisive as the yardstick for verifying compliance with the ownership unbundling rules is European law as incorporated through the Energy Community. The condition in the conclusions of the Preliminary Decision, whereby the final decision on certification is subject to changes of Article 32(3) of the Electricity Market Law by introducing economic management rights as an alternative to ownership over the transmission assets ("*lay down that the final decision on the certification of PRIVATE JOINT STOCK COMPANY NATIONAL POWER COMPANY UKRENERGO may be adopted after amending part three of Article 32 of the Law as regards establishing the transmission system operator as the owner by right of economic management of the transmission system.*") would, in itself, not be in compliance with Energy Community law unless complemented by amendments to other legislation such as the Law on Pledge. Hence, the Secretariat does not agree with the conclusion of NEURC that changes to the Electricity Market Law envisaging economic management

²² Commission's Opinion on URE's draft certification decision for PSE S.A. of 9 April 2014 (C(2014) 2471; 093-2014-PL); Commission's Opinion on ERSE's draft certification decision for REN and RENGasodutos of 12 May 2014 (C(2014) 3255; 094-2014-PT, 095-2014-PT); Commission's Opinion on ANRE's draft certification decision for Transelectrica of 12 October 2015 (C(2015) 7053; 117-2015-RO).

²³ Article 4 of the Law of Ukraine "On Pledge", Law No. 2654-XII of 02.10.1992

right over the transmission assets as an alternative to ownership would be sufficient to comply with the requirement of ownership. Moreover, conditioning the certification of a TSO on legislative changes is also critical from a general administrative law point of view, as *Ukrenergo* cannot influence let alone achieve them.

Based on the above, it is obvious that *Ukrenergo* does not own the electricity transmission assets as required by Article 9(1) of the Electricity Directive, and does not enjoy and exercise rights over them equivalent to an owner. Therefore, the TSO does not comply with that provision and cannot be certified under the ownership unbundling model.

The Secretariat is without prejudice to compliance of *Ukrenergo* with the other requirements enshrined in Article 9 of the Electricity Directive.

3. Conditions imposed by the Preliminary Decision

In the Preliminary Decision, NEURC envisages that „*the final decision on certification of Ukrenergo will be adopted after implementing the required measures envisaged in the justification to the preliminary decision on certification*”. The measures requested are amendments to the statute of the company and amendments to Article 32 of the Electricity Market Law. These conditions seem to be meant not necessarily as conditions to be imposed by the final decision, but as pre-conditions to be fulfilled by *Ukrenergo* before issuing the final decision. As set out above, these conditions are not suitable to remedy the key obstacle to compliance of *Ukrenergo* with Article 9(1) of the Electricity Directive, the lack of ownership. As elaborated above, the envisaged changes to the Electricity Market Law essentially would deem the exercise of economic management rights over the transmission assets as sufficient for compliance with the ownership unbundling, without however, changing the nature and scope of that legal title and making it equivalent to ownership. As explained above, in the current legal situation the economic management right does not amount to a right equivalent to that of an owner of the transmission assets.

In order to rectify these shortcomings, either legal amendments that would strengthen the economic management right (namely allowing pledging of the assets) or legal amendments to the Electricity Market Law allowing for the independent system operator (ISO) model and introducing the necessary adaptations would be necessary.

IV. Conclusion

Based on the information displayed in the Preliminary Decision, the Secretariat concludes that *Ukrenergo* cannot be certified under the ownership unbundling model at this point in time given the specifics of Ukrainian legislation.

Pursuant to Article 3 of the Electricity Regulation, NEURC shall take utmost account of the above comments of the Secretariat when taking its final decision regarding the certification of *Ukrenergo*. According to the same provision, NEURC must issue the final decision within two months upon receiving the Secretariat's Opinion. NEURC shall communicate its final decision to the Secretariat and publish its decision together with the Secretariat's Opinion.

The Secretariat will publish this Opinion on its website. The Secretariat does not consider the information contained therein to be confidential. NEURC is invited to inform the Secretariat within

five working days following receipt of this opinion whether and why it considers that this document contains confidential information which it wishes to have deleted prior to such publication.

Vienna, 5 February 2020



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