

## CONDITIONAL APPROVAL

### of the unbundling model for the transmission system operator of natural gas in Ukraine

as required under the Gas Sector Reform Implementation Plan

6 May 2016

#### 1. Introduction

##### 1.1. Proposals for unbundling of the transmission system operator for natural gas

The Energy Community Secretariat (*the Secretariat*) reviewed and analysed the Ministry of Energy and Coal Industry of Ukraine's (*the Ministry*) proposal for the unbundling of the transmission system operator for natural gas (*the TSO*) in Ukraine.

Based on Paragraphs 18 and 19 of the Plan of Measures to Reform the Gas Sector,<sup>1</sup> the plan for unbundling of the TSO had to be developed by the Ministry in cooperation with the National Commission for State Energy and Public Utilities Regulation (*the Regulator*) and the Antimonopoly Committee of Ukraine. When approved by the Secretariat, it has to be submitted for adoption to the Cabinet of Ministers of Ukraine.

Proposals by the Ministry on the restructuring of NJSC "Naftogaz of Ukraine" (*Naftogaz*), including the unbundling of natural gas transmission operations as required by Energy Community law and the Law of Ukraine on the Natural Gas Market (*the Gas Law*),<sup>2</sup> were initially submitted on 15 February 2016. Following a hearing conducted at the Secretariat's premises on 14 March 2016, an update was sent to the Secretariat on 23 April 2016.

The present analysis provides the Secretariat's comments concerning compliance of the Ministry's proposals with the requirements for unbundling and independence of the TSO stipulated in Directive 2009/73/EC<sup>3</sup> and the Gas Law. Other factual circumstances and legal proceedings, even if not directly related to unbundling of the TSO, were considered by the Secretariat to the extent

<sup>1</sup> Decree No 375-r of the Cabinet of Ministers of Ukraine of 25 March 2015 "On the Reform of the Gas Sector"

<sup>2</sup> Law of Ukraine No 329-VIII of 9 April 2015 "On the Natural Gas Market"

<sup>3</sup> Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, as incorporated and adapted for the Energy Community by Ministerial Council Decision 2011/02/MC-EnC of 6 October 2011

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they directly or indirectly affect the operation of the future TSO and, on a larger scale, developments of the natural gas market in Ukraine.

The Secretariat also took into account other suggestions concerning unbundling of the TSO in Ukraine, including the restructuring plan elaborated by *Naftogaz* and circulated on 29 March 2016. Additionally, the present analysis incorporates inputs received from various stakeholders at and after the hearing of 14 March 2016.

The present analysis shall be without prejudice to the Secretariat's Opinion to be delivered during the procedure of certification of the designated TSO under Article 3 of Regulation (EC) No 715/2009.<sup>4</sup>

## 1.2. Legal background for unbundling of the TSO

The TSO is required to be unbundled, *i.e.* separated from other activities in the natural gas sector not related to the transmission, in accordance with the requirements stipulated in Directive 2009/73/EC, as applicable to Ukraine by virtue of its membership in the Energy Community, transposed to the Ukrainian national legislation by the Gas Law.

The Gas Law requires unbundling of the TSO either in accordance with the rules related to the ownership unbundling model (Article 23 of the Gas Law) or the independent system operator model (Article 27 of the Gas Law).

The Ministry's proposals envisage ownership unbundling of the State-owned TSO under Article 23 of the Gas Law which corresponds to Article 9 of Directive 2009/73/EC. Besides proposing ownership unbundling of the TSO within the meaning of the Gas Law and Directive 2009/73/EC, the Ministry's proposals also extend to other activities in the natural gas sector, including unbundling of distribution and storage system operators, as well as the management of assets of natural gas undertakings.

## 2. Analysis

### 2.1. Selection of the ownership unbundling model

The ownership unbundling is not only the most common model for unbundling of electricity and natural gas TSOs among EU Member States and Contracting Parties of the Energy Community, but it is also the most effective one which allows promoting investments in natural gas infrastructure in a non-discriminatory way, fair access to the network for new entrants and transparency in the market. Furthermore, ownership unbundling is an effective and stable way to

<sup>4</sup> Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005, as incorporated and adapted for the Energy Community by Ministerial Council Decision 2011/02/MC-EnC of 6 October 2011

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solve the inherent conflict of interests and to ensure security of supply.<sup>5</sup> The Secretariat has always expressed its preference for an unbundling of *Naftogaz* in accordance with the ownership unbundling model and commends the Ministry for basing its proposal on that model.

Ownership unbundling under Article 9 of Directive 2009/73/EC implies ownership of the natural gas transmission system by the designated TSO and the TSO's independence from any natural gas and/or electricity production and supply activities. In effect implementation of the ownership unbundling requires the separation of natural gas transmission activities from the vertically integrated corporate structure of *Naftogaz* and, in particular, from production and supply of natural gas and/or electricity. In case the designated TSO will be State-owned/controlled, as in case of Ukraine, Article 9(6) of Directive 2009/73/EC offers the additional possibility of a structural separation within the State's structures.

**2.2. Compliance with the ownership unbundling rules**

**a) Ownership of the natural gas transmission system**

Article 9(1)(a) of Directive 2009/73/EC requires that “each undertaking which owns a transmission system acts as a transmission system operator”. The same requirement is transposed into Ukrainian national legislation by Article 23(2) of the Gas Law.

Based on the information provided by the Ministry and *Naftogaz*, the natural gas transmission system of Ukraine (*the GTS*), which also includes transit pipelines, is historically owned by the State and is currently administered by the State Property Fund of Ukraine (*the SPF*). According to Ukrainian legislation, the GTS is and will remain State property not subject to privatisation.<sup>6</sup>

Due to contractual arrangements between the SPF and *Naftogaz* on the one hand and between *Naftogaz* and PJSC “Ukrtransgaz” (*Ukrtransgaz*) on the other hand,<sup>7</sup> the GTS is used by *Ukrtransgaz* and is accounted for on its balance sheet. This provides *Ukrtransgaz* with certain commercial management rights over the GTS and related assets. However, such rights are limited through imposed reporting on the property's status and its use, as well as through restricted decision making with regard to necessary planning, operation and maintenance of the GTS. Consequently, *Ukrtransgaz* not only does not own the GTS but it also does not possess rights comparable to ownership which would allow for effective decision making *inter alia* with regard to the development of the GTS and investment management.

<sup>5</sup> Recital 8 of Directive 2009/73/EC

<sup>6</sup> Article 7 of the Law of Ukraine No 192/96-VR of 15 May 1996 “On the Pipeline Transport”, as further amended, Article 21(1) of the Gas Law, Article 40 of the Law of Ukraine No 2665-III of 12 July 2001 “On Oil and Gas”, as further amended, and Article 5 of the Law of Ukraine No 2163-XII of 4 March 1992 “On Privatisation of the State Property”, as further amended.

<sup>7</sup> Agreement No 76 of 4 February 1999 on the use of the State property not subject to privatisation between the SPF and *Naftogaz*, and Agreement No 19/275 of 17 June 1999 on the use of the State property not subject to privatisation between *Naftogaz* and *Ukrtransgaz*.

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As a matter of principle, ownership unbundling of the future TSO will demand ownership by the TSO over the GTS.

The Ministry discards full ownership of the GTS by the TSO as being not in line with the Ukrainian legislation. At the hearing, the Ministry explained that Ukraine’s legal system banned privatisation of the gas transportation system and that transferring assets from the State to a State-owned company was considered privatisation under Ukrainian law. As a consequence, the Ministry’s proposals are based on the premise that the GTS may not be owned by the designated TSO.

*Naftogaz* supports the Ministry’s interpretation of the privatisation ban imposed by the legislation currently in force, but suggests transferring the GTS as a contribution to the share capital of the designated TSO following legislative amendments.

At the outset, the Secretariat recalls that ownership of the natural gas transmission system by the TSO is one of the key elements of the ownership unbundling model as it ensures the uncompromised independence of the TSO in making 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 natural gas 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.

The Secretariat thus favours a solution where the future TSO and not a third party will own the GTS. It notes that transfer of the GTS as a contribution to the share capital of the designated TSO may not necessarily be considered as privatisation of State property, having in mind that in the Ministry’s proposals the future TSO is seen as a State-owned company. In case such assets are not put for sale, *i.e.* there is no paid transfer,<sup>8</sup> the privatisation rules should not apply in the Secretariat’s understanding. Due to shareholding restrictions imposed by Article 27(1) of the Gas Law, even after potential engagement of an external investor (the GTS Partner) the TSO and its all assets, including those related to the GTS, would anyway remain at the State’s control. However, the Secretariat is aware that for the GTS to be transferred to the TSO, amendments to the Law on Privatisation of the State Property<sup>9</sup> may be necessary in order to establish an unrestricted right to transfer State-owned assets as a contribution to the share capital of the TSO. Additional amendments to the laws of Ukraine with regard to *inter alia* the State’s property management rights<sup>10</sup> may be needed.

<sup>8</sup> Article 1 of the Law of Ukraine “On Privatisation of the State Property”: “*Privatisation of the State property (hereinafter – privatisation) – paid transfer of the property owned by the State <...> for the benefit of individuals and entities which may be buyers under this Law, to improve the socio-economic efficiency and attract funds for restructuring of the national economy*” [emphasis added by the Secretariat].

<sup>9</sup> Law of Ukraine No 2162-XII of 4 March 1992 “On Privatisation of the State Property”, as further amended

<sup>10</sup> Law of Ukraine No 185-V of 21 September 2006 “On the Management of State Property”, as further amended

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At the same time, the Secretariat is ready to accept other alternatives to a transfer of assets to the extent this is indeed excluded by Ukrainian law currently in force and that legislative changes to the rules prohibiting privatisation are lengthy and politically difficult to achieve. Any deviations from the ownership requirement established in Article 9(1)(a) of Directive 2009/73/EC will be considered only if it is clearly proven that transfer of ownership to the TSO is legally or technically impossible.

*b) “Quasi-ownership” of the natural gas transmission system*

As pointed out by the European Commission (*the Commission*) in a letter to the Ministry,<sup>11</sup> in exceptional cases the Commission in its case law on designation of TSOs in the EU accepted that where the TSO does not own the transmission system the rights to manage the system were provided to the TSO through a lease or concession agreement. However, in such cases provisions of relevant agreements were required to ensure 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.

In particular, as regards use and disposal of the transmission system assets, the Commission requires that (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; (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.<sup>12</sup>

The Ministry’s proposals elaborate on several options for “quasi-ownership” of the GTS, including concession, lease and commercial management rights. However, the Ministry by itself disqualifies possible transfer of the GTS to the TSO under the legal title of lease or commercial management rights as not meeting the criteria of effectiveness and completeness of the legal title in the context of the natural gas market developments in Ukraine and requirements of EU law. At the hearing, the Ministry considered the management of transmission system assets under concession agreements as the best available option of “quasi-ownership”, also with regard to the possible engagement of an external investor (the GTS Partner) in the TSO.

At the same time, the Ministry acknowledged that the concession legislation in force<sup>13</sup> needs to be amended before it is suitable for unbundling. *Naftogaz* also pointed out that under the current legislation, the State’s influence over day-to-day business of the concessionaire is very strong.

<sup>11</sup> See Page 3 of Preliminary Comments and Question by the European Commission on Naftogaz Unbundling Proposals, as attached to the Letter No ENER B4/MC/tj s(2016) 515341 of 1 February 2016.

<sup>12</sup> 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).

<sup>13</sup> Law of Ukraine No 997-XIV of 16 July 1999 “On Concessions”, as further amended

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The Secretariat agrees that the Ukrainian legislation currently in force does not give the concessionaire rights to use and dispose of relevant assets equivalent to those of an owner and, therefore, fails to comply with the ownership unbundling rules as interpreted by the Commission.

In particular, the following key shortcomings were identified in the Law on Concessions: (i) transmission of natural gas is not included to the list of activities eligible for concessions by the State;<sup>14</sup> (ii) the concession tender procedure, which seems to be the only defined procedure for granting the concession, is not functional in case of transferring assets to the TSO;<sup>15</sup> (iii) the grantor's exclusive right to authorise the operation of the concession object is not in line with the necessary TSO independence in planning, construction, operation, financing and maintenance of the transmission system;<sup>16</sup> (iv) using the concession object as a guarantee (collateral) in acquiring financing on the capital markets is not envisaged; and (v) predefined contents of the concession contract and its termination conditions do not reflect the guarantees requested by case law, including long-term commitments by the grantor and compensations upon the expiry of the concession.<sup>17</sup>

Therefore, significant legislative amendments would have to be introduced to the legal framework regulating concessions in Ukraine first of all allowing for the GTS to be granted to the designated TSO on concession without tendering procedures and furthermore, *inter alia*, establishing clear principles for an independent and fully operational TSO as a concessionaire in line with the requirements stipulated in the Gas Law, effective and unrestricted usage and disposal of the GTS for the TSO's needs, including possible use of the GTS as collateral for the debt financing, as well as long-term commitments with regard to the development of the GTS and the mechanism for compensating the TSO after the expiry of concession arrangement.

The Secretariat is of the opinion that concession may be applied as a legal title for the transfer of the GTS to the TSO but only if necessary legislative framework is introduced and contractual arrangements are made so as to ensure full compliance with the ownership unbundling rules.

Given that both compliance with the main rule established by Article 9(1)(a) of Directive 2009/73/EC, *i.e.* transferring the GTS's ownership to the TSO, as well as the derogation based on

<sup>14</sup> Only distribution and supply of natural gas are included as activities for exercising of which the State's ownership rights may be granted on concession (Article 3(2), item 11 of the Law of Ukraine "On Concession"). This list, as established in the Law, is expressly determined as finite (Article 3).

<sup>15</sup> Compare Article 2, items 4 and 5 with Article 6(3) of the Law of Ukraine "On Concessions". No other procedure for granting the concession, except for the concession tender, is envisaged.

<sup>16</sup> The grantor holds an exclusive right to authorise management (operation) of the concession object, and the concessionaire has the right to manage (operate) such object only if so provided by the terms and conditions of the concession contract (Articles 17(1), item 2 and Article 18(1), item 2 of the Law of Ukraine "On Concessions"). As regards operation of the GTS as of a concession object and the TSO's independence thereto, respective measures have to be clearly and thoroughly elaborated by the Law.

<sup>17</sup> See Articles 10 and 15 of the Law of Ukraine "On Concessions". The substantial conditions of concession contracts and requirements for their implementation have to be clarified and elaborated in more detail.

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the Commission's case law, *i.e.* a concession agreement between the State and the designated TSO, require legislative changes, the Secretariat requests the Ministry to explore and justify why the second option is superior to the first one.

*c) Control rights and formation of corporate bodies*

Articles 9(1)(b), (c) and (d) and 9(2) of Directive 2009/73/EC establish independence requirements for the TSO concerning control rights in direct or indirect relations with production and/or supply undertakings or their shareholders and formation of the TSO's corporate bodies. These requirements were transposed to the Ukrainian legislation by Articles 23(3) and (4) of the Gas Law.

Practical implementation of these provisions has to be ensured at two levels – managing the control rights upon the TSO<sup>18</sup> and designing its corporate set-up. At this stage it seems sufficient to insist that restrictions related to the control over the TSO and requirements set for the formation of its corporate bodies, as established by Directive 2009/73/EC and, consequently, by the Gas Law, are mandatorily implemented by shareholders (or bodies implementing the State's shareholding rights) of the TSO and the TSO itself through their respective decisions, acts and bylaws.

The Ministry emphasises the necessity for a corporate governance of the TSO in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises (SOE). At the hearing, the Ministry announced that the new governance would include having the TSO's activities controlled by a separate department within the Ministry of Energy subject to "Chinese walls" and having a compliance officer in place, in order to separate the management of the TSO from general policy-making functions. The new department would prepare key decisions, annual meetings of TSOs, determine the direction of the company, regulations of governing bodies, issue new shares, approve annual reports, *etc.* This department would not be subject to orders from the Minister. The Secretariat welcomes this announcement.

The Directive's requirements for the control of the TSO and its corporate setup may be designed, elaborated and implemented in parallel to the corporate governance design for the designated TSO. Proper compliance with these requirements will be scrutinised by the Secretariat during the TSO's certification procedure under Article 3 of Regulation No 715/2009.

*d) Separation within the State*

The ownership unbundling rules equally apply both to private and public entities. Article 9(6) of Directive 2009/73/EC envisages that two separate public bodies may be seen as two distinct persons and should be able to control production and supply activities on one hand and

<sup>18</sup> Control rights include (i) the power to exercise voting rights, (ii) the power to appoint members or the TSO's corporate bodies and those legally representing the TSO, and (iii) the holding of majority share (Article 9(2) of Directive 2009/73/EC and Article 23(3) of the Gas Law).

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transmission activities on the other hand provided they are not under the common influence of another public entity in violation of the ownership unbundling rules.<sup>19</sup>

Therefore, the public bodies concerned must be truly separate and Ukraine must demonstrate that such separation is clearly and transparently enshrined in national law and duly complied with.

Under the Ministry's proposals, the State's shareholding rights in the TSO are planned to be transferred to the Ministry thus giving it *inter alia* control and supervision rights over the TSO equivalent to those of a shareholder, whereas respective rights in the State-owned natural gas and/or electricity production and supply undertakings are proposed to remain with the Ministry of Economic Development and Trade of Ukraine, *i.e.* the separation within the State is proposed to be ensured by control powers distributed between two ministries.<sup>20</sup>

By contrast, *Naftogaz's* restructuring plan aims at transferring the State's shareholding rights in the TSO to the SPF. The SPF is a governmental agency which is not only fully subordinated to the Government, namely to the Prime Minister, but also depends on it in terms of formation, functioning and budgeting.

In principle, both proposals are viable subject to proper establishment and implementation of the independence requirements deriving from EU natural gas *acquis*.

The Commission's certification practice<sup>21</sup> shows that splitting control over energy undertakings between different ministries may be considered compliant with the requirement of Article 9(6) of Directive 2009/73/EC, provided that the respective ministries are accorded full independence from other parts of the Government in their respective policy areas. In this regard it is of crucial importance that the relevant provisions of national law defining the competences of the Governmental bodies, their decision-making rights and interaction, provide for their full independence and absence of any conflict of interests.

Based on the Commission's opinions, at least the following measures have to be expressly stipulated and elaborated in the national legislation, as well as enforced in practice: (i) each ministry shall have clearly defined and exclusive powers within a specific field of competence and

<sup>19</sup> See Section 2.2, page 10 of the Commission Staff Working Paper – Interpretative Note on Directive 2009/72/EC concerning common rules for the internal market in electricity and Directive 2009/73/EC concerning common rules for the internal market in natural gas – the Unbundling Regime, 22 January 2010.

<sup>20</sup> See proposed schemes in Figures 2 and 3, and argumentation elaborated in Sections 3 and 4.1 (the assessment part) of the Ministry's proposal.

<sup>21</sup> For example: Commission's Opinion on DERA's draft certification decision for *Energinet* (gas) of 9 January 2012 (C(2012) 88; 006-2011-DK); Commission's Opinion on e-Control's draft certification decision for *VÚN* (electricity) of 29 March 2012 (C(2012) 2244; 009-2012-AT); Commission's Opinion on Energy Markets Inspectorate's draft certification decision for *Affärsverket svenska kraftnät* of 30 April 2012 (C(2012) 3011; 017-2012-SE); Commission's Opinion on BnetzA's draft certification decision for *TenneT* of 6 September 2012 (C(2012) 6258; 029-2012-DE); Commission's Opinion on Nma's draft certification decision for *GTS* of 1 July 2013 (C(2013) 4205; 069-2013-NL); Commission's Opinion on NCC's draft certification decision for *Litgrid* of 4 July 2013 (C(2013) 4247; 071-2013-LT).

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shall not be subordinate to other ministries or other Governmental bodies; (ii) individual ministers shall have an independent power of decision making in the areas for which they are responsible and shall enjoy a high degree of independence; (iii) the Prime Minister or President shall be precluded from giving orders or instructions as regards the minister's responsibilities in a designated area; (iv) insofar as an issue is subject to a collegial decision by the Government, the independent power of decision making of individual minister within its field of competence shall not be limited; (v) split competences in the energy sector shall be designed so as to prevent from overlapping decision making powers and conflict of interests; and (vi) separation of interests between two public bodies must be ensured not only at the level of the members of Government, but also at the level of supporting staff and administration.

From the explanations provided in the Ministry's proposals, it becomes clear that such measures establishing independence of the relevant entities within the State are yet to be introduced to Ukrainian law. This shall include amendments to the Law on the Cabinet of Ministers of Ukraine<sup>22</sup> ensuring the fulfilment of all requirements of Article 9(6) of Directive 2009/73/EC and the related case law, especially those related to exclusive decision-making rights by individual ministers within the scope of their specific field of competence, functional interaction between the ministers in terms of the collegial decision-making by the Cabinet of Ministers but without subordinate relationship between each other, and excluding instructions or orders by the Prime Minister (or President) to individual ministers within the field of their designated competence.<sup>23</sup> Subsequently, ministries' regulations shall also be reviewed and adjusted.

As regards *Naftogaz'* proposal based on control over the designated TSO by the SPF, the latter's independence from the Government and especially from the Prime Minister would require for its complete reorganisation. The Secretariat has serious doubts if that would be possible given current status of the SPF. Therefore, it suggests to stick to the Ministry's proposal and to seek for a separation of control within the State based on two public bodies of equal hierarchical status without elements of subordination.

Furthermore, the Secretariat notes that the SPF is an agency primarily responsible for implementation of the national policy on privatisation, lease, use and sales of State-owned property. The SPF's exclusive role in privatisation implies that there is no guarantee that in future the SPF will not be assigned with respective competences in management the State-owned property used for production of natural gas or generation of electricity once they are positioned for privatisation. In case the SPF would (also) be assigned with the State's shareholding rights in the TSO, such a situation would cause an infringement of the TSO's independence requirements under Articles 9(1)(b)-(d) and 9(3) of Directive 2009/73/EC.

<sup>22</sup> Law of Ukraine No 794-VII of 27 February 2014 "On the Cabinet of Ministers of Ukraine", as further amended

<sup>23</sup> For example, Article 42(1)(2) of the Law of Ukraine "On the Cabinet of Ministers of Ukraine" expressly provides for the Prime Minister's power to direct, coordinate and supervise the work of the members of the Cabinet of Ministers, *i.e.* individual ministers. Independence of individual ministers in their decision making rights is not envisaged in any way.

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In any case, it is important to note that the current legal system of Ukraine does not ensure the preconditions required for due separation within the State of the control over the TSO on one hand and natural gas production and supply businesses on the other hand. Thus necessary legislative amendments have to be prepared and processed for their adoption without any delay. Proper legal establishment and enforcement of the requirements in question will be scrutinised by the Secretariat during the TSO's certification procedure under Article 3 of Regulation No 715/2009.

e) Vertical relations between natural gas and electricity markets

To avoid undue influence arising from vertical relations between natural gas and electricity markets, Article 9(3) of Directive 2009/73/EC clarifies that ownership unbundling applies also across the natural gas and electricity markets, thereby prohibiting joint influence over an electricity generator or supplier and a natural gas TSO, or a natural gas producer or supplier and an electricity TSO.

The Ministry proposes the transfer of control over both natural gas and electricity transmission operations to the Ministry, while generation/production and supply activities in both the gas and electricity sectors are proposed to be assigned under the supervision of the Ministry of Economic Development and Trade of Ukraine. In practice such transfer would mean that current control over the natural gas TSO has to be moved from the Ministry of Economic Development and Trade to the Ministry (which currently controls the electricity TSO *NEK "Ukrnenergo"*), whereas the Ministry's control rights over electricity producers (e.g. *NAEK "Energoatom"*) shall be assigned to another ministry, e.g. the Ministry of Economic Development and Trade.<sup>24</sup>

Such a proposed separation of transmission activities from generation/production and supply business is in principle compliant with Article 9(3) of Directive 2009/73/EC subject to proper implementation of measures for separation within the State as elaborated above.<sup>25</sup>

2.3. Other issues raised under the Ministry's proposals related to the unbundling

a) Formation and designation of the TSO

One of the questions raised in the hearing was whether the designated TSO should be a newly incorporated company, or rather the existing *Ukrtransgaz*, potentially following a reorganisation and obviously separation from the current vertically integrated corporate structure of *Naftogaz*.

The Secretariat notes that *Ukrtransgaz* has never been designed to be an independent TSO separate from other interests in the market. This does not only refer to the independence as required under Directive 2009/73/EC and the Gas Law, but also to the company's non-existing functional unbundling in line with the requirements of the Second Energy Package. Moreover, not

<sup>24</sup> See Figure 2 (page 55) of the Ministry's proposals.

<sup>25</sup> See Secretariat's comments in Section 2.2(d) of this Analysis.

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all *Ukrtransgaz's* activities, assets and liabilities (whether based on law or contract) are related to its natural gas transmission operations.

The Secretariat believes that the future TSO should not be burdened by the legacy of a number of non-essential functions and assets currently belonging to *Ukrtransgaz*, as well as a number of existing liabilities. The incorporation of a new company tailored to perform TSO's activities and its subsequent formation in line with the ownership unbundling rules is therefore preferable. A newly established TSO might be an advantage also in case of the engagement of the external investor (the GTS Partner). The creation of a new company functioning as TSO does obviously not exclude that the staff required for these functions is being transferred from the existing *Ukrtransgaz*.

*b) Unbundling and ownership of natural gas storage systems*

As concerns the future ownership of Ukraine's underground natural gas storages (*UGS*), the Secretariat agrees in principle that the natural gas *acquis* allows for a designation of a combined transmission and storage system operator in line with Article 29 of Directive 2009/73/EC. Consequently, the Ministry's proposed transfer of *UGS* from current corporate structure to the one of the future TSO does not result in non-compliance with Energy Community law.

That said, the designated storage system operator, *i.e.* the subject which would operate the *UGS*, must ensure fair and transparent access to the *UGS* and at all times follow the requirements regarding tasks and duties pertaining to storage system operators from Directive 2009/73/EC (*inter alia* Article 13) and Regulation (EC) No 715/2009/EC (Articles 15, 17, 19, 20 and 22).

The Secretariat believes that the key factors in guiding the decision as to how the ownership of *UGS* has to be structured, positioned and their business model ensured should be the commercial viability of *UGS* and their role in the natural gas market on one hand and well-specified and reasoned security of supply concerns on the other hand. Furthermore, tailor-made management and operation models may be applied for individual storage facilities on case-by-case basis.

The Secretariat takes note that the Commission intends to conduct an in-depth economic and technical assessment of the existing storage capacity in Ukraine<sup>26</sup>. The Secretariat requests to conduct but not wait for such analysis when initiating the TSO unbundling process. In any event, a clear separation (economic and legal) of *UGS* activities from TSO activities is a precondition for effective unbundling of the TSO.

*c) Reorganisation of natural gas production and supply undertakings*

The Secretariat considers the schedule set by the Ministry for restructuring *Naftogaz* by separating natural gas production assets in "3-5 months since the date of the PJSC *Ukrtransgaz* transfer to the Ministry of Energy and Coal Industry"<sup>27</sup> as overly ambitious and premature. The Secretariat is

<sup>26</sup> Letter of 11 April 2006 from Mr Šeřčovič to H.E. Mr Yatsenyuk (No Ares (2016) 819598)

<sup>27</sup> See Section 8.2 of the Ministry's proposals and corresponding entries in Annex 1 thereto (pages 62-63).

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concerned that this process, which again needs a deeper economic and strategic analysis, if executed as suggested by the Ministry, would slow down and most probably jeopardise the unbundling of the TSO which must be an absolute priority.

The Secretariat also considers that, for privatisation of or introducing a foreign strategic partner in *Naftogaz* to remain policy options, *Naftogaz* remaining an integrated company with trade, supply and production businesses (but without transmission and perhaps storage) may be more attractive. With such a portfolio of activities *Naftogaz* may be better positioned in future negotiations with potential foreign partners. As the public service obligation related to the supply of natural gas to household customers and district heating companies imposed on *Naftogaz* will anyhow cease in April 2017,<sup>28</sup> this may additionally increase the attractiveness of the company for investment.

Once the proper unbundling of natural gas system operators is in place and all necessary *acquis* compliant secondary natural gas market legislation adopted, the potential that *Naftogaz* abuses its currently monopolistic position in the natural gas market should be significantly diminished.

d) Competences of the Ministry

By claiming several competences listed in Section 3, page 9 of the Ministry's proposals, the latter impinges on competences to be given to the national regulatory authority. The implementation of these proposals would cause non-compliance with the natural gas *acquis* and the Gas Law.<sup>29</sup>

First of all, the Ministry claims competence in "approving the operator of Ukraine's Unified GTS", *i.e.* of the TSO. However, both licensing (Articles 4(3)(1) and 9 of the Gas Law) and certification (Articles 24 and 26 of the Gas Law) of the TSO, *i.e.* proceeding eventually leading to designation of the transmission system operator, is an exclusive competence of the Regulator.

Secondly, the Ministry's reference to its function of "approving annual financial and investment plan <...> of state companies under [the Ministry's] administration" creates an ambiguity with the Regulator's competence to approve the development plan of the TSO and to monitor its implementation under Article 30 of the Gas Law.

The Secretariat, therefore, asks the Ministry to introduce relevant corrections in the Ministry's regulations when preparing other amendments in line with the unbundling plan so as no uncertainties are left with regard to the competences of the Regulator and its independence.

e) Other effects upon the TSO's unbundling process

<sup>28</sup> Regulation on Imposition of Public Service Obligations on Subjects of the Natural Gas Market to Ensure the Safeguarding of General Public Interests in the Functioning of the Natural Gas Market (Relations During the Transitory Period), as approved by Decree No 758 of the Cabinet of Ministers of Ukraine of 1 October 2015 and further amended by Decree No 791 of 7 October 2015 and Decree No 872 of 30 October 2015

<sup>29</sup> Refer to the Ministry's powers listed in Section 3, page 9 of the Ministry's proposals.

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The Secretariat took into account the Ministry's argumentation on the potential effects of the TSO's unbundling process over the commitments under loan agreements entered into by *Naftogaz*, as well as ongoing arbitral proceedings in the Gas Sales Arbitration and the Gas Transit Arbitration between *Naftogaz* and OOO "Gazprom" (*Gazprom*) under the Rules of the Stockholm Chamber of Commerce.<sup>30</sup>

As concerns loan agreements entered into by *Naftogaz*, the Secretariat will cooperate closely with the Ukrainian authorities in the course of the unbundling process to minimize any possible impact on existing loan agreements.

As concerns the ongoing arbitral proceedings between *Naftogaz* and *Gazprom*, the Secretariat is aware that adverse effects may arise from (i) removal of assets from *Naftogaz*, and (ii) transfer from *Naftogaz* of its shares in *Ukrtransgaz*. As these proceedings are important also from the perspective of ensuring Ukraine's compliance with the Energy Community *acquis*, the Secretariat will not take any action which could possibly jeopardise these proceedings. It is well understood that full unbundling of the TSO under the ownership unbundling rules, including a transfer of the GTS and the transit agreement concluded between *Naftogaz* and *Gazprom*, to a designated TSO will be viable only after delivering the arbitration award.

This does not, however, prevent the Ukrainian authorities and *Naftogaz* from taking a number of actions regardless of any loans and already before the arbitration awards are delivered, including incorporation of a new TSO company, setup of its corporate governance structure in compliance with the ownership unbundling rules and introduction of necessary legislative amendments necessary to implement the transfer of the GTS and to ensure a proper separation within the State. Furthermore, activities related to domestic transmission can be assigned to the newly established TSO already at an early stage, potentially backed up by service agreements with *Naftogaz* on issues such as balancing of maintenance for a transitional period. In any event, the existing loan agreements and the ongoing arbitral proceedings may not delay the immediate start of the TSO's unbundling process, while safeguarding *Naftogaz'* ability to amend the contracts with *Gazprom* and assign the transit contract as amended to the future TSO.

### 3. Conclusions

**The Secretariat requests the Ministry to prepare the plan for unbundling of the TSO and to submit it for adoption to the Cabinet of Ministers of Ukraine without any delay so as to ensure that unbundling comes into effect and its implementation begins not later than by 1 June 2016 based on the following preconditions:**

- (1) The TSO shall be unbundled in compliance with the ownership unbundling rules under the terms and conditions stipulated in Directive 2009/73/EC and elaborated through the TSO certification practice by the Commission.

<sup>30</sup> See Section 5, pages 39-44 of the Ministry's proposals.

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- (2) The future TSO shall be formed on the basis of a newly incorporated company separately and independently from the current vertically integrated structure of *Naftogaz*.
- (3) Control over the TSO shall be assigned and the TSO's corporate setup shall be designed, elaborated and implemented so as to ensure its independence from production and/or supply business and to prevent from any conflict of interests, and in line with the best international corporate governance standards.
- (4) Full ownership of the GTS by the TSO shall, as a priority, be based on transfer of the transmission related assets and the required legal amendments must be implemented as soon as possible.
- (5) Any "quasi-ownership", such as a concession, may be opted for only if the transfer of the GTS and all associated legal changes are deemed and properly justified as being less feasible than the legal changes required for the transfer of full ownership.
- (6) The future transfer of the GTS-related assets, as well as of contractual liabilities and human resources shall be planned already now so as to ensure that only those clearly related to the TSO's functions are being transferred and no additional burdens are created upon effective operational functioning of the TSO.
- (7) Legislative amendments necessary to (i) proceed with the transfer of the GTS to the TSO, whether under full ownership or under a concession agreement, and (ii) ensure separation within the State, i.e. full independence of two public bodies which will control the TSO on one hand and the State-owned production and supply undertakings on the other hand, shall be prepared and submitted for adoption without any delay.
- (8) Competences and powers of the Ministry, as of the public body exercising the State's shareholding rights in the TSO, shall be reviewed and, where necessary, adjusted so as to ensure that there are no overlaps with competences and powers of the Regulator or interferences to its independence.
- (9) Ownership and/or operation of UGS and natural gas production capacities, including all legal and corporate reforms to be implemented in this regard, shall be considered as an issue separate from the ownership unbundling of the TSO and shall in no way jeopardise necessary proceedings thereto.
- (10) It is understood that any removal of assets from *Naftogaz* and transfer from *Naftogaz* of its shares in *Ukrtransgaz*, the actual transfer of the GTS for the usage and disposition by an ownership unbundled TSO as well as the transit agreement will be implemented only after delivery of arbitration awards in ongoing arbitral proceedings between *Naftogaz* and *Gazprom*. However, this shall not in any way delay other actions necessary for the ownership unbundling of the TSO.

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The plan for unbundling of the TSO, as to be prepared by the Ministry and adopted by the Cabinet of Ministers of Ukraine, shall be based on the action plan structured by the Secretariat and attached as Annex to this Analysis.

Failure to ensure timely preparation and adoption of the plan for unbundling of the TSO and/or its proper implementation may cause enforcement measures to be initiated by the Secretariat under the Treaty establishing the Energy Community.

\* \* \*

## ANNEX

### action plan for unbundling of the transmission system operator for natural gas in Ukraine

	Actions	Deadlines / timeframe	Comments
<b>1. Plan for unbundling of the TSO</b>			
1.1.	Final preparation of the plan for unbundling of the TSO and its submission to the Cabinet of Ministers for adoption	<b>By 31 May 2016</b>	<ul style="list-style-type: none"> <li>- The plan for unbundling of the TSO shall be prepared by the Ministry as required under the Plan of Measures to Reform the Gas Sector of 25 March 2015.</li> <li>- The plan for unbundling of the TSO shall be structured in line with the Secretariat's conclusions stipulated in this Analysis.</li> <li>- Unbundling of the TSO shall be processed in compliance with the rules on ownership unbundling.</li> <li>- Actions aimed at reforming the natural gas market of Ukraine, but not related to the separation of transmission operations and TSO's activities, shall be clearly separated from the unbundling process.</li> </ul>
1.2.	Adoption of the plan for unbundling of the TSO by the Cabinet of Ministers	<b>By 1 June 2016</b>	<ul style="list-style-type: none"> <li>- Apart from requirements stemming from this Analysis, the plan for unbundling of the TSO shall indicate bodies placed by the Cabinet of Ministers in charge for implementation of relevant actions.</li> </ul>
<b>2. Establishment and formation of the TSO</b>			
2.1.	Incorporation of the new company aimed for its further formation and designation as of the TSO	By 1 August 2016	<ul style="list-style-type: none"> <li>- The future TSO shall be formed on the basis of a newly incorporated company separately and independently from the current structure of <i>Naftogaz</i>.</li> <li>- The State's shareholding rights in the newly incorporated TSO shall be assigned to the Ministry.</li> </ul>
2.2.	Formation of the TSO's corporate setup in compliance with the ownership unbundling rules and in line with the best international corporate governance standards	By 1 October 2016	<ul style="list-style-type: none"> <li>- Shareholding (control) rights in the TSO shall be exercised and its corporate structure set in line with Articles 9(1)(b), (c) and (d) of Directive 2009/73/EC.</li> </ul>

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	<b>Actions</b>	<b>Deadlines / timeframe</b>	<b>Comments</b>
			- Corporate management structure of the TSO shall be designed in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises.
2.3.	Development of legislative amendments necessary to ensure separation within the State and their submission to the Verkhovna Rada of Ukraine for adoption	By 1 November 2016	<ul style="list-style-type: none"> <li>- Legislative amendments are needed to ensure proven independence of two public bodies which will control the TSO on one hand and the State-owned production and supply undertakings on the other hand.</li> <li>- Relevant amendments to the Law on the Cabinet of Ministers of Ukraine and, where relevant, to other laws shall be developed upon consultation with the Secretariat so as to ensure full compliance with Article 9(6) of Directive 2009/73/EC and relevant TSO certification practice by the Commission.</li> </ul>
2.4.	Adoption of secondary legislation acts (or amendments thereto) necessary to ensure separation within the State	In 30 days after adoption of amendments referred to in Item 2.3	<ul style="list-style-type: none"> <li>- Following adoption of legislative amendments referred to in Item 2.3, several secondary legislation acts, including regulations of Ministries in charge, will need to be adjusted upon consultation with the Secretariat.</li> <li>- Competences of the Ministry shall be reviewed and adjusted so as to ensure that there are no overlaps with the Regulator's competences and powers of or interferences to its independence.</li> </ul>
<b>3. Transfer of transmission related assets to the TSO</b>			
3.1.	Identification of transmission related assets, contractual liabilities and human resources currently possessed by <i>Ukrtransgaz</i> which are necessary for the TSO's activities	By 1 October 2016	- Transfer of assets, contractual liabilities and human resources from <i>Ukrtransgaz</i> to a newly incorporated TSO company shall be planned so as to ensure that only those related to the TSO's functions are being transferred.
3.2.	Development of legislative amendments necessary to ensure an effective transfer of transmission related assets to the TSO and their submission to the Verkhovna Rada of Ukraine for adoption	By 1 November 2016	<ul style="list-style-type: none"> <li>- Full ownership of transmission related assets and any "quasi-ownership", such as concession, may be opted for only if the transfer of the assets as contribution to the share capital of the TSO is properly justified as not feasible.</li> <li>- Legislative amendments to be developed upon consultation with the Secretariat are needed to ensure an</li> </ul>

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	<b>Actions</b>	<b>Deadlines / timeframe</b>	<b>Comments</b>
			<p>effective transfer of transmission related assets to the TSO, whether as of a full ownership (contribution to a share capital) or under the concession agreement.</p> <p>- Apart from the above referred corrections, additional adjustments may be needed in legal acts regulating management of the State-owned companies and/or property.</p>
3.3.	Actual transfer of transmission related assets, contractual liabilities and human resources to the TSO under adopted legal scheme*	In 30 days after delivery of arbitration awards*	<p>- Actual transfer of transmission related assets for usage and disposition by an ownership unbundled TSO will have to be implemented immediately after delivery of arbitration awards in ongoing arbitral proceedings between <i>Naftogaz</i> and <i>Gazprom</i>.</p> <p>*Technical, economic and legal viability of earlier transfer of <i>Ukrtransgaz's</i> assets and resources which are not relevant to arbitral proceeding shall be considered.</p>
<b>4. Designation and certification of the TSO</b>			
4.1.	Designation and certification of the TSO	In 6 months after date referred to in Item 3.3.	<p>- Designation and certification of the TSO shall be processed by the Regulator under the terms and conditions stipulated in the Gas Law.</p> <p>- Proper unbundling of the TSO will be scrutinised by the Secretariat during the certification procedure under Article 3 of Regulation No 715/2009.</p>

\* \* \*