



**Certification and Unbundling of Ukrenergo, Status
Report September 2023**

by the Energy Community Secretariat

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PURPOSE STATEMENT

Compliance assessment of the compliance by the Ukrainian electricity TSO Ukrenergo with the unbundling requirements of Directive 2009/72/EC

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Ukraine Energy Market Observatory
Assessment 18/23

Certification and Unbundling of Ukrenergo
Status Report September 2023

Introduction:

The Energy Community Secretariat has been requested by the European Network of Transmission System Operators for Electricity (ENTSO-E) to provide a status report on the compliance by the Ukrainian electricity TSO *Ukrenergo* with the unbundling requirements of Directive 2009/72/EC, in the context of *Ukrenergo*'s prospects to become a member of ENTSO-E.

Background

On 17 May 2021, *Ukrenergo* submitted an application for certification under the ISO model to the National Energy and Utilities Regulatory Commission (NEURC). On 1 October 2021, NEURC adopted the Preliminary Decision, by which it conditionally certified *Ukrenergo* as an electricity TSO.

On 25 November 2021, the Secretariat issued Opinion 4/21 on the preliminary certification of *Ukrenergo* and raised several concerns related, inter alia, to the independence of *Ukrenergo*. On 17 December 2021, *Ukrenergo* was conditionally certified under the ISO model by Decision No 2589 issued by NEURC¹.

According to NEURC's Decision, both the Ministry of Energy (the Ministry), as sole shareholder of *Ukrenergo* and *Ukrenergo* had to fulfil several conditions by pre-determined deadlines spanning from 3 days to one year².

In April 2023, the Secretariat sent a questionnaire inquiring on the status of unbundling of *Ukrenergo* to NEURC, which submitted the responses to the questionnaire in May 2023. Upon review of NEURC's questionnaire and after additional consultation with the Ministry of Energy of Ukraine, the Secretariat identified four main areas in which action is still needed in order to ensure full compliance with the ISO model of unbundling.

I. The Ministry's control over the supply branches of *Ternopiloblenergo*, *Zaporizhiaoblenergo*, and *Cherkasyoblenergo*

¹ NEURC Decision No. 2589 dated 17 December 2021.

² The conditions imposed by the Final Decision refer to four main areas in which NEURC considered that the ISO unbundling requirements had not been fulfilled: the separation of control over or any rights by public bodies in production and supply activities, on the one hand, and transmission activities on the other; potential conflicts of interest associated with the Ministry of Energy's control over *Ukrenergo*; the disposal, by the transmission system operator, of the required financial, technical, physical and human resources to carry out its tasks; and the role of the transmission system owner.

According to Article 13(2)(a) of the Electricity Directive, an ISO may be designated only where it complies with Articles 9(1)(b), (c) and (d) of the Electricity Directive. The control by the Ministry over the supply activities of retail suppliers runs against the unbundling requirements, namely the separation of control over any rights in supply activities, on the one hand, and transmission activities, on the other.

By Order of the CMU of 15 September 2021 No 1222-r “Some issues of management of state-owned objects”, the retail companies *Ternopiloblenergo*, *Zaporizhiaoblenergo*, *Mykolaivoblenergo*, *Khmelnytskoblenergo*, *Cherkasyoblenergo* were transferred to the Ministry. They are vertically integrated undertakings including electricity supply activities. The Final Decision requested the Ministry to retain control only over distribution activities and bring the charters of the DSOs transferred to the Ministry in line with the unbundling requirements by January 2022.

The shares in the supply activities were expected to be transferred to *Energoatom*. The shares in *Energoatom* are held by the Government, which is functionally separate in terms of exercising shareholding rights, from the Ministry, the shareholder in *Ukrenergo*. A joint-stock company *UDGG (Ukrainian Distribution Grids)* was established in November 2022³, with the aim to act as a manager of the state-owned Ukrainian DSOs. The Ministry is the sole shareholder and authorized body for the management of state corporate rights. So far, only two DSOs, *Khmelnytskoblenergo* and *Mykolaivoblenergo*, have been spun off and transferred under *UDGG*. The supply activities have been transferred to *Energoatom*. The agreement between *Cherkasyoblenergo* and *Energoatom* conditioned the separation on the successful privatization of the state’s stake in the company. In the Secretariat’s understanding, the privatization process is still ongoing. The assets of *Zaporizhiaoblenergo*, which owns *Zaporizhia Electricity Supply*, were seized by a court resolution. Since DSO *Zaporizhiaoblenergo* is operating on the territory currently occupied by the Russian Federation, the Secretariat understands that compliance is not possible until the liberation of the territories. With regard to *Ternopiloblenergo*, a decision on the sale of the shares in *Ternopil Electricity Supply* to *Energoatom* or entering into any kind of corporate agreements to prevent the control of the Ministry over the supply company is still pending.

On 28 July 2023, *UDGG* increased its authorized capital and commenced issuing additional shares, which is aimed to complete the transfer of the authorised capitals of *Cherkasyoblenergo*, *Zaporizhiaoblenergo* to the authorised capital of *UDGG*. At the same time, in order for the separation between supply and transmission activities to be finalised, it is necessary for the supply branches of *Cherkasyoblenergo*, *Zaporizhiaoblenergo* to be transferred to *Energoatom*. The Ministry communicated no timeline for finalising these two processes.

II. The draft laws amending the Law of Ukraine “On Central Bodies of Executive Power” and “On the management of state property”

In order to ensure the independence and autonomy of the Deputy Minister, which exercises of corporate management rights in *Ukrenergo*, he/she needs the authority to sign ministerial orders issued in his/her exclusive competence to carry out all tasks related to the management of shares in, and the management of the state property operated by *Ukrenergo*. The Final Decision imposed amendments to the Law of Ukraine “On Central Bodies of Executive Power” in this regard, by December 2022. A draft law amending the Law of Ukraine “On Central Bodies of Executive Power” has passed inter-ministerial consultations and is expected to be adopted by the end of the year. The draft law was consulted with the Secretariat earlier this year and in general, the amendments

³ Resolution of the CMU No. 1336 of 29 November 2022

proposed are suitable to eliminate the inconsistency between provisions governing the unbundling of TSOs and the management of state property, as they enhance the prerogatives and independence of the Deputy Minister in charge of managing the rights in *Ukrenergo* (including the authority to sign ministerial orders).

According to Article 13(2)(d) of the Electricity Directive, the transmission system owner has to demonstrate its ability to comply with its obligations under Article 13(5) of the Electricity Directive, namely to - provide all the relevant cooperation and support to the ISO for the fulfilment of its tasks. The economic management rights agreement between *Ukrenergo* and the Ministry puts the obligation to contract insurance on the TSO, and not on the system owner. The Final Decision required that amendments be made to the Law of Ukraine "On Critical Infrastructure" to ensure coverage of asset liabilities by the owner of the transmission system by February 2022. It also requested changes to the economic management rights agreement, to provide for the coverage of the responsibility of the Ministry regarding network assets, with the exception of obligations regarding the tasks of *Ukrenergo*. The draft law promoted by the Ministry currently envisages coverage of the transmission system operator's insurance by the system owner only with regard to "critical" situations, and leaves the regular insurance to the system operator, which in itself does not ensure full compliance with the standards in the Electricity Directive.

The Secretariat is currently reviewing the two draft laws and will recommend amendments in order to make them fully compliant with the *acquis*. The draft laws are expected to be adopted by the end of the year.

III. Only three independent members of Ukrenergo's Supervisory Board are appointed.

Ukrenergo's supervisory board was designed to mitigate unfettered control by the Ministry. While the supervisory board's seven members are formally appointed by the Ministry, four must be independent from the state administration and selected through a competitive procedure. NEURC's Final Decision imposed an obligation that by December 2021 all members of the Supervisory Board are appointed in accordance with the procedure described in the Law on Management of State Property.

Currently, only three out of four independent members are appointed, together with three representatives of the state. The procedure for appointing the fourth independent member has not been completed and the Ministry did not communicate any timeline for its completion.

The main task of the Supervisory Board is to control and supervise the operation of the management board, including by appointing the chairperson and members of the management board, and the compliance officer. The fact that the majority of the Supervisory Board's members must be, at all times, independent from the state administration, is essential to ensure the independent operation and commercial activity of *Ukrenergo* and shelter it from interference from the Cabinet of Ministers or the Ministry. It is therefore imperative that all four independent members of the Supervisory Board be appointed. This has not been the case since 14 April 2022, when the mandate of an independent member of the Supervisory Board expired and, though a selection procedure had been initiated, it has never been completed. The Secretariat has repeatedly called upon the Ministry and NEURC to rectify the situation.

IV. The Minister of Energy's Order 408/2022 imposing a mechanism for the organization and functioning of internal control and risk management

Order 408/2022 imposes a mechanism for the organization and functioning of internal control and risk management in the system of the Ministry. The purpose of Order 408 is the organization and implementation of internal control, risk management, improvement of management processes, supervision of budgetary discipline and prevention of illegal, ineffective use of state property and other material resources in the Ministry. Subjects of internal control include enterprises in which the Ministry performs corporate rights management, including *Ukrenergo*. Order of the Ministry No 158 dated 3 May 2023 introduced amendments to Order 408/2022. Even if the new version takes into account some particularities of state enterprises like *Ukrenergo* (by entrusting a Deputy Minister assigned to exercising control over *Ukrenergo* with the decision-making), *Ukrenergo* is still subject to internal control over management and the supervisory functions. Several concerns remain:

- The regular risk identification by the Ministry extends to an unspecified notion of “risks which can help or prevent organisation in achieving its goal”. It is not limited, as it should, to security risks, risks associated with illegal use of funds and corruption risks.
- The persons in charge of risk management have the authority to collect information on the internal environment, execution of processes and operations of the subject of internal control. This means, in practice, that high officials within the Ministry will gain access to all information on *Ukrenergo*’s operations, including its day-to-day activities. Access to such information has the potential of creating serious conflicts of interest incompatible with the requirements of the ISO model of unbundling.
- Monitoring and control measures, still part of Order 408, are *de facto* creating a supervisory function of the Ministry over *Ukrenergo* and are therefore in breach of the ISO unbundling requirements. This in particular affects the functions of the independent supervisory board of the company. According to the Law of Ukraine on Joint-Stock Companies and *Ukrenergo*’s charter, the supervisory function must be solely performed by the (by majority independent) supervisory board (as well as internal and independent external auditor), in particular with regard to compliance, risk assessment and internal control.

Overall, Order 408 *de facto* establishes a parallel control system by the Ministry, which results in conflicting lines of accountability, in particular with regard to the accountability towards the (independent) supervisory boards. Order 408 also entrusts the Ministry with the power to institute control measures and make decisions beyond the scope of a system owner under the ISO model of unbundling. Order 408 should be further revised to ensure that *Ukrenergo* can operate entirely independently from the interference of the Ministry and of the Minister of Energy.

Conclusion

In the Secretariat’s assessment, *Ukrenergo* has been diligently implementing the requirements from unbundling and certification.

As regards the issues pertaining to the sphere of the Ministry controlling the TSO, the first two (I-II) issues identified above, though indeed important to ensure unbundling, would not, in themselves, be sufficient to request the recertification of *Ukrenergo*, since progress has been registered since NEURC’s Final Decision.

The last two issues (III-IV) identified by the Secretariat relate to core aspects of unbundling and require further attention and action from the Ministry.