

TO: Clients and Friends of the Firm

FR: Frishberg & Partners

RE: Energy Law

I. Introduction

Once, a long, long time ago, Ukraine was one of the most industrial and productive Soviet republics in such areas as metallurgy, chemical manufacturing, military manufacturing, machinery production, among others. Importantly, all of the above fields demanded significant energy sources.

The development of energy power resources, and the corresponding energy infrastructure, gives Ukraine a unique geo-political status in the former Soviet territories. Ukraine's border with Poland served not only as a military barrier to threats from Western countries, but also facilitated the flow of energy resources to the rest of the Eastern Bloc countries, which relied on a constant supply of the Soviet Union's energy for their fight against the "evil" forces of capitalism.

When Ukraine declared its independence in 1991, it became the successor of a relatively highly developed energy sector with a complex infrastructure. However, this uniquely developed energy sector had its own peculiarities. For instance, as a result of the state's former stronghold over this militarily important asset, the energy sector remains non-transparent and poorly adapted toward involvement by independent private entities. Add to this other inherited problems, such as the Chernobyl disaster, the complicated sale of "OblEnergos" (regional energy distribution companies) and the arrest of Prime-Minister Pavel Lazarenko (for laundering millions of dollars derived from energy-related deals), no wonder many foreign investors tend to smile, very sarcastically, when they hear the phrase "investment in the Ukrainian energy sector."

Nevertheless, the 2000-2002 Privatization Program (which, incidentally, is still effective as of September 2007; however, the 2007-2009 Program should soon be passed) called for comprehensive privatization of the energy sector and modernization of the energy market along with its cohesive procedures. Unfortunately, due to Ukraine's regulated prices for electric power, the energy sector continues to be one of the roughest markets to enter in Ukraine for foreign investors, raising a legitimate question whether foreign investment in this arena is worth the trouble. And yet, the allure of investing in energy distribution companies with monopolistic-like holds on certain regions has caught the attention of several potential foreign investors.

Below we limit our discussion to the legal aspects of the energy sector.

II. The Energy Sector

A. Introduction

As a rule, only two principal ways exist for a foreign company or an individual to invest in the Ukrainian energy sector: (i) purchase shares in an existing company; or (ii) participate in the formation of a new energy-related company. In order to invest in the energy sector, it is important to know that each Ukrainian energy company maintains a monopoly-like hold over a certain region of the country. It is equally essential to be familiar with the relevant laws, governing electrical energy and entities that participate in energy-related businesses.

Law No. 575/97-VR “On Electric Power Engineering,” dated October 16, 1997 (the “Law”) provides the necessary legal and organizational basis for activities in the energy sphere. The Law also regulates all relations in connection with the production, transfer, supply and use of energy, the maintenance of energy safety in Ukraine, competition and the protection of consumer rights and workers’ rights. Under the Law, the term “energy” includes electrical or heating energy, produced by electrical power stations for further sale.

Although not always apparent in practice, the Law provides for certain functional requirements for the energy sector, including: (i) a constant and uninterrupted balance between production and use of electricity via the establishment of a single, controlled (operative-technological) management of the “unified energy system”; and (ii) a centralized heat supply to consumers via heating networks and boilers which are a part of the unified energy system. Incidentally, the Law defines “unified energy system” as the aggregate of power stations, the electricity and heating networks and other objects, which are unified by a joint mode of production, transmission and distribution of electrical and heating energy under centralized management.”

B. State Control

As the imprisoned ex-Prime Minister Lazarenko knew all too well, the energy sector is one of the biggest moneymakers for the state budget. It is not surprising, therefore, that the Law provides for a great deal of governmental regulation in the said sphere, beginning with a Vice Prime Minister, who is responsible solely for fuel and energy issues. The next rung in the hierarchy of the energy sector is the Ministry of Fuel and Energy, which regulates strategic issues regarding the energy availability conditions for the Ukrainian economy. Under the Vice Prime Minister and the Ministry of Fuel and Energy, there are numerous other state organs involved in regulating the energy sector.

The Law stipulates a number of general principles which shape state policies in the energy sector, including the state regulation of activity in the energy sphere, the creation of safety measures,

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