



UKRAINE

*Follow-up Report
on the Investment
Climate and
Market Structure
in the Energy Sector*



2006



Energy Charter
Secretariat

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MAIN FINDINGS OF THE SECRETARIAT

1. Investment Climate

1.1. Legal and regulatory environment

During the recent years, Ukraine has adopted new legislation, regulations and procedures aimed at the improvement of the investment climate in its economy at large and the energy sector in particular. Major new laws and regulations include:

- The new Ukrainian Civil Code (in force since January 1, 2004) established for the first time a hierarchy of laws and regulations that apply to civil relations. The Code states that international agreements have the highest order of priority along with the Constitution of the country.
- A law amended certain legislative acts in conformity with the new Civil Code, and in particular rescinded the authority of a head of a tax administration to freeze withdrawals from taxpayers' accounts. Such a freeze can now only be imposed by a court order. However, the ability of the tax authority to "attach" taxpayers' assets was preserved (Law No. 2631-IV of June 2, 2005).
- As a the first step in a sweeping reform of the permitting system and to harmonise Ukrainian business laws with applicable European legislation a law was passed to the effect that business permits may now be obtained by declaration (Law No. 2806-IV of September 6, 2005).
- Legislative measures have been adopted which aim at improving the financial position of fuel and energy companies, preventing their bankruptcy and making them more attractive for investment (Law No. 2711-IV on Measures to Secure Steady Operation of the Fuel and Energy Sector).

In addition, during 2005 and early 2006, the Ukrainian Government passed a number of other laws and regulations and essential amendments to existing ones, seeking to facilitate mutual investment protection and intensified international cooperation in economic activities [No. 2935-IV dated October 5, 2005, No. 3095-IV dated November 16, 2005, No. 3384-IV dated January 19, 2006, No. 3464-IV dated February 22, 2006, No. 3535-IV dated March 15, 2006, No. 3577-IV dated March 16, 2006; the Ukrainian Law on Joint Investment Institutions (Mutual and Corporate Investment Funds) and some others].

Important **draft legislation** includes a Law on Joint Stock Companies, which has been submitted for review to Supreme Rada committees. The bill seeks to resolve controversies and improve legal control of joint stock companies, as well as to improve corporate governance.

There are also plans to amend the Law on Joint Investment Institutions (Mutual and Corporate Investment Funds), seeking to improve diversification of investment assets and incorporate the amendments necessitated by the adoption of the new Civil Code. Hopefully, the Law would help draw more investment resources into the Ukrainian economy. Its adoption and enactment is expected in 2007.

To **work with the investor community**, an Advisory Board for Foreign Investment in Ukraine was reinstated and a relevant Expert Commission formed by Presidential Decree No. 625 (April 11, 2005). On July 19, 2005, the President of Ukraine issued Decree No. 1116 on

Measures to Improve Investment and Innovative Activities in Ukraine. This decree sets up a National Council for Investment and Innovation. Subsequently, the Council of Ministers established a Centre for Encouraging Foreign Investment and appointed members to its Supervisory Board (Government Resolution No. 303 of August 2, 2005).

Based on the deliberations of the Advisory Board for Foreign Investment in Ukraine at the end of 2005, the Ukrainian President issued Decree No. 1513 on Measures to Improve the Investment Climate in Ukraine (October 28, 2005) and Decree No. 300 on the Investment Priority Action Plan (April 10, 2006). The documents require the drafting of a law aimed at encouraging innovation, the development of investor compensatory mechanisms in free trade areas, the greater use of concessions, the introduction of fast-lane land allocation for investment projects, and generally the removal of barriers to investment.

Regarding **exceptions to national treatment of investors**, Ukraine maintains six notifications in the register of exceptions (the “Blue Book”).

- An important restriction related to *land use* is now slated for gradual relaxation. In particular the Ukrainian Land Code has been supplemented allowing title to non-farm lands to be given to joint ventures involving foreign individuals or legal entities. Another positive development in this area includes rules land plots under property to be privatised must be sold to the investor in 2006. The Law on the 2006 Government Budget also amended Article 129 of the Land Code governing the sale of government or public lands to foreign states and foreign legal entities: Now such land sale are done by the privatisation authorities acting under the instructions of the Council of Ministers and in agreement with the Supreme Rada. These amendments are expected to have a positive impact on the real estate market and to provide to prospective investors better terms of use of privitised property.
- *Privatisation* has also undergone certain changes. A Regulation on Tendering for the Sale of Joint Stock Company Blocks of Shares has settled matters relating to foreign investor participation in tenders. In addition, UCM Decree No. 617 of May 11, 2006 repealed UCM Decree No. 853, approving the Procedure for Foreign Business Entity Transactions Involving Products of Ukrainian Origin within Ukraine without Taking Them out of the Ukrainian Customs Territory, dated July 30, 1996.
- Regarding *foreign labor*, the Council of Ministers has amended Para. 7 of the Regulation on Work Permit Issuance to Foreigners and Stateless Persons. It is now possible to issue multi-annual work permits to intra-company expatriates (executives, managers and specialists) and persons performing services without commercial presence in Ukraine, rather than the one-year permits available to other classes of employees.

In the past few years, Ukraine has seen **tax legislation changes and incentives** contributing to the improvement of the investment climate in the country. In particular, a new (lower) profit tax rate at 25% has been in effect since January 1, 2004. The profit tax rate reduction was accompanied by a tax base enlargement.

To maintain the investment capacity of government-owned companies, in particular those in the electricity sector rules have been adopted which exempt from tax profits/income of energy companies operating under regulated prices and tariffs (Energoatom, Energorynok, Ukrenergo), if the income is used to implement government industry programs, to secure government guarantee obligations, to complete power units, and to improve their reliability and safety. Another law allowed coal companies to write off tax assessments amounting to about \$112 million), which were beyond the statute of limitations in 2003-2004.

The new Ukrainian Tax Code (now under consideration) will be based on a mix of direct and indirect taxes. It will reduce the number of taxes and thus increase the efficiency of the tax system in general. To enable an environment friendly investment and innovation, the taxpayer will have the right to reduce the tax base by the amount used for reinvestment. The Code envisages including in the profit taxpayer category legal entities (both Ukrainian residents and non-residents) as well as permanent representatives of Ukrainian non-residents. The new Tax Code incorporates EU recommendations.

Despite the progress in building a better investment environment many problem areas are still either insufficiently addressed or yet to be dealt with. In particular, the regulatory and policy framework and policy coherence are still inadequate. The respect of the rule of law, the weak court system and protection of property rights (including corruption issues), entry barriers, operational and exit restrictions, the possibility of retroactive de-registration of businesses, and arbitrary tax policy combined with high taxation and slow VAT reimbursement remain important issues. Recent legislation which amounts to a moratorium on bankruptcy of firms with state shares, raising questions about fairness in competition, and concerns about state meddling in pricing of energy are issues of concern and risk impacting the investment climate negatively. Also proper privatization procedures could help to improve the investment climate.

In the energy sector, terms of access remain restricted in upstream oil and gas, pipelines and some other sub-sectors. Bureaucratic hurdles in access to geology and geophysics data, in licensing and permitting, and for the affirmation of property rights for produced oil and gas continue to exist. Transparency in gas pipeline operations, underground storage, and import and export transactions continues to be inadequate and produces negative signals to investors. The introduction of a very high export duty on natural gas is likely to have a negative impact on investment in exploration and production of hydrocarbons.

Demand-side policies (especially energy efficiency) have yet to produce tangible results, particularly as regulated prices tend to be set at politically determined low levels rather than reflecting true market values. This is especially valid for the electricity sector and district heating.

1.2. Energy Sector Policy

The priorities of the Ukrainian Government's *energy policy* include:

- Adopting the required legal framework for Ukraine to become an equal member of the EU;
- Ukraine's accession to the WTO;
- Gradual elimination of restrictions and non-tariff barriers preventing bilateral trade;
- Investment climate improvement by introducing a non-discriminatory and transparent business environment and streamlining of administrative procedures.

Ukraine's key energy policy tasks and priorities are defined in the Energy Strategy for the Period until 2030 as adopted by the Cabinet of Ministers in March 2006. The Strategy proceeds from the understanding that Ukraine has limited endowment with conventional energy resources and has to rely on imports, and that it also suffers from lack of diversification of the imports of key energy products, such as oil, natural gas, and nuclear fuel. For these reasons, the Strategy highlights the importance of rational use of energy, the promotion of domestic energy production, and switching to alternative energy sources.

The Government expects that the implementation of the Strategy will make Ukraine an influential and active participant in international energy relations and help consolidate the nation's energy security. Key tasks that are to be implemented in a relatively short time include:

- Legal and technical harmonisation of the Ukrainian energy sector with the basic rules of the EU internal market, and intensification of energy policy cooperation between Ukraine and the EU;
- Further reform of electricity sector ownership;
- Integration of the Ukrainian Interconnected Power System into the UCTE;
- Rehabilitation of high voltage power transmission lines;
- Infrastructure development with a view to diversify gas and oil supplies;
- Continued review of financial and legal restructuring opportunities for the gas transit business;
- Further reform of the coal sector;
- Greater use of alternative energy sources and cooperation in implementing energy-saving projects; and
- Continued work to implement an action plan at the Ukrytie ("Shelter") facility at the Chernobyl Power Plant, to make Power Unit 4 environmentally safe.

With the objective of improving the legal framework of the *privatization policy* a number of bills have been submitted for approval to the central executive authorities and Supreme Rada committees. They seek to enhance public sector efficiency by optimising the public asset structure and developing a differentiated privatisation mechanism for each asset category (e.g. a draft Law Amending Certain Privatisation Laws).

2. Market Structure

In the **hydrocarbons industry** several acts were introduced aiming at the streamlining of operations. Pursuant to Cabinet of Ministers' Decree No. 1205 (December 15, 2005), the Ukrainian Ministry of Fuel and Energy was authorised to administer the government's corporate rights in the National Joint Stock Company "Naftogas Ukrainy". Naftogas Ukrainy entities account for about 94% of total natural gas production and 97% of total oil and condensate production.

Order No. 142 of the Ministry of Fuel and Energy (March 24, 2003) set up a Central Commission for Gas, Gas Condensate and Oil Field Development and Underground Gas Storage Operations. The Commission is authorized to decide on the commercial development of a field or separate oil and/or gas reservoir based on an application from an oil and gas resource user, pursuant to the Law of Oil and Gas (Article 36).

Exploration and development activities are carried out with the support of the government. However, due to inadequate funding, only one discovery (Aksutinskoye gas condensate field) was made in 2005 as a result of government-funded exploration. Four other fields were discovered by an affiliate of Naftogaz Ukrainy. Nonetheless, the existing Ukrainian reserves do not allow for steady incremental gas production.

Large investments are required to develop prospective fields, most of which are located offshore, but foreign investors have in the past found it difficult to enter the sector. Recently, the government has made the first steps in attracting foreign companies to exploration and production of hydrocarbons. In December 2005, the Government issued a tender on PSA

terms in the Kerch block of the Black Sea, and in April 2006, the Cabinet of Ministers declared Vanco International Ltd. (Switzerland) to be the winner of the tender. Another tender may be held for the Skif block in the western part of the Black Sea.

Onshore, Naftogaz Ukrainy and Shell (UK) signed a cooperation agreement and Naftogaz's affiliate Ukrgasbydobuvannya and Shell executed a joint operations agreement on June 8, 2006. Under the terms of the agreement, Shell will work on eight blocks in the Dneprovsko-Donetsky Basin licensed to Ukrgasvydobuvannya. Shell will have a 50% share in the operations (except for a field currently under development) in exchange for obligations to acquire seismic data and drill exploration wells within three years. Work is expected to start in June 2006.

Downstream operations (refining, distribution, and trade) in liquid hydrocarbons have been privatized and competitive markets have emerged. Oil product excise rates and charges on crude and product imports have been reduced. Simultaneously, the earlier additional customs duty on motor fuels was cancelled and a foreign trade quota system introduced for domestic oil and motor fuel exports. This helped establish better government control on domestic crude trade and product exports, and at the same time it helped open up the domestic market for petrol and diesel imports.

Ukraine is cooperating with key stakeholders in the provision of information and the build-up of emergency liquid fuels stocks.

Despite some recent upgrades, Ukrainian refineries continue to suffer from low sophistication resulting in high yields of the heavy end of the barrel, poor product quality and low margins. There are plans to build a new refinery in Western Ukraine, but it remains unclear what markets it would serve and how it would be supplied with crude.

Oil pipeline operations are under the umbrella of Naftogaz Ukrainy. The inlet and outlet oil pipeline throughput capacity in Ukraine totals 109 and 70 MMTA, respectively, but the system is utilized at a low rate (total about 46.5 MT). In 2005, transit oil volumes accounted for 67% of total oil shipments with the remaining 33% moving to Ukrainian refineries. The financial situation of oil transport companies is a cause of concern and rules out work on upgrades and proper maintenance, mainly due to a heavy tax burden and oil pipeline capacity underutilisation (less than 40%). The technical condition of pipeline facilities continues to decline. The Odessa-Brody pipeline is still largely empty and only partially used in reverse direction, and its extension to Plock and Gdansk in Poland is yet to go beyond the project phase.

Main gas pipeline operations are under the umbrella of Naftogaz Ukrainy. Current laws state that gas companies, main pipeline facilities and underground gas storages are government property and cannot be privatized. Foreign investment in the gas sector may be channeled via joint ventures in infrastructure projects. Transparency in gas imports, transit and storage operations has improved, but many issues still linger and are sometimes quoted as sources of concern to various parties in Europe. Naftogaz Ukrainy and government offices are cooperating with suppliers, shippers and recipients of gas to improve the framework of operations and the security of gas supply.

In the **coal sector** the main challenges are to make it profitable, to enable its operation in a market environment, and to attract investment. To address these issues, a Coal Industry Ministry has been established, a decision has been approved to reduce by 30% the railway rate for coke, and exports of coking and boiler grade coal exports, and some coal sector payroll arrears have been decreased. Six coal companies are slated for privatization in 2006.

In the **power and heat sector** new Laws have been adopted to address the need of settling the debts of energy companies in arrears by using payments for energy used, to introduce criminal sanctions for theft of electricity, and to set basic rules for district heating. Despite these efforts, however, the power market is still prone to distortions and faces considerable difficulties on the road to liberalization and competition. Three regional electricity companies are slated for privatisation in 2006.

* * *

The efforts of the Government to improve the business environment and the investment climate in the country are beginning to bear fruit. For the purpose of creating a reliable investor right protection, the President and the Cabinet of Ministers have passed a number of acts aimed at achieving a change in foreign business attitudes to the Ukrainian economy. Despite the risks associated with the political situation, investments grew in the first quarter of 2006 by 15.9%, which was a rate 4.5 times higher than in the corresponding period of 2005. Foreign direct investment amounted to \$922 million, or 3.9 times more than last year's value, setting an all-time record during Ukrainian independence.

However, these achievements are still below the levels of many of the other countries in the region. The energy sector as a whole, and in particular the upstream oil and gas industry, the main pipelines industry, and the power and heat industry still lag behind the economy at large in terms of positive investment climate, liberalization and competitiveness.

FOLLOW-UP REPORT
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REPUBLIC OF UKRAINE

Introduction

The European Union (EU) enlargement of January 1, 2004 has resulted in significant geopolitical and economic changes in Europe, opening up new prospects for cooperation between Ukraine and the EU.

Ukraine's accession to the WTO and European integration are among the top priorities of the national foreign economic policy and are considered to be a systemic factor of national economic development, foreign trade liberalisation and a transparent environment for foreign investment.

Ukrainian strategic tasks continue to include a far-reaching reform of the energy sector as a constituent of the country's national security, as well as strengthening of the economic growth through the use of relevant economic policy instruments.

Despite a slower growth of Ukrainian GDP that dropped from 12.1% in 2004 to 2.6% in 2005, the past year has seen a number of positive economic trends.

In particular, individual real earnings have been 11.7% up and social benefits 41.5% up.

The inflation rate was on decline in 2005. Annualised consumer price growth in early 2005 exceeded 14.0%, dropping to 10.3% towards yearend. Producer price development trends were even more favourable. Year results 2005 showed a 9.5% producer price growth that fell to an annualised rate of 8.1% in February 2006. It is almost a three-fold decrease compared to 2004 when producer prices grew by 24.1%.

Consolidated budget income experienced a sharp increase from 26.5% of GDP in 2004 to 31.7% of GDP in 2005. A dramatic growth of tax revenues put Ukraine's consolidated budget deficit down from 3.2% in 2004 to 1.8% in 2005, with 92.0% of the deficit funded through privatisation cash receipts rather than offshore borrowings.

Foreign investment flowed into Ukraine at a faster pace. The year 2005 saw a record high FDI inflow that rose by USD 7,328.0 million (or 81%) reaching, as of January 1, 2006, USD 16,375.2 million, or USD 349.0 per capita of the country's population (Source: Ukrainian State Statistics Committee). In October 2005, Krivorozhstal was sold for USD 4.8 billion, a record amount for Ukraine. Sizeable FDI was attracted in the banking sector: foreign investors bought the Aval Bank (for USD 1.1 billion) and initiated the purchase of UkrSibBank and Mria Bank, contributing to lower interest rates in the Ukrainian economy and the introduction of new banking methods.

Ukrainian banks stepped up money-lending to the economy. The year 2005 alone saw their credit portfolio grow by 61.9% to 143.0 billion hryvnias. A positive trend was also an increase in long-term loans which accounted for 61.8% versus only 54.2% in 2004.

Payroll arrears were on decline virtually in all economic sectors. Such arrears dropped by 14.9% to 959.7 million hryvnias in early 2006 against early 2005.

International Advanced Research Centre studies indicate that if maintained through 2006, such trends would lead to a further economic growth in Ukraine.

Positive change also surfaced in the legislative framework in terms of improving the investment climate in Ukraine.

For example, adopted on June 23, 2005 was Ukrainian Law No. 2711-IV on Measures to Secure Steady Operation of the Fuel and Energy Sector, focusing on improving the financial situation of fuel and energy companies, preventing their bankruptcy and making them more attractive for investment.

In addition, during 2005 and early 2006, the Ukrainian Government passed a number of new laws and regulations and essential amendments to existing ones, seeking to facilitate mutual investment protection and intensified international cooperation in economic activities (No. 2935-IV dated October 5, 2005, No. 3095-IV dated November 16, 2005, No. 3384-IV dated January 19, 2006, No. 3464-IV dated February 22, 2006, No. 3535-IV dated March 15, 2006, No. 3577-IV dated March 16, 2006; the Ukrainian Law on Joint Investment Institutions (Mutual and Corporate Investment Funds) and some others).

This study has been drawn on the basis of ECS comments contained in Document CC 212 of June 5, 2002 and constitutes a logical follow-up to Ukraine's 2002 Investment Climate and Market Structure Report (ICMS-6).

The purpose of this study is to reflect the economic trends of national development and changes affecting the investment attractiveness of the fuel and energy complex, indicating the key priorities of Ukrainian energy sector development in the short term.

This report is based on the official position of Ukrainian government authorities.

More detailed information on Ukrainian legislation and real economic sectors is available at the respective websites of Ukrainian Supreme Rada (www.rada.gov.ua), the Ukrainian Cabinet of Ministers (www.kmu.gov.ua) and www.liga.kiev.ua.

1. Political and economic processes in Ukraine

1.1. National development priorities

Ukraine continues to forge ahead on the path of reform.

The Government Action Programme “Meeting the People Halfway” as approved by Ukrainian Supreme Rada Decree No. 2426-IV of February 4, 2005 specifies development priorities and strategies for all economic sectors seeking to step up national economic growth and strengthen Ukraine’s positions for strategic partnership with the European Union and Russia.

The key priority of the industrial and investment policies in market conditions is to create a competitive production capability on domestic and international markets. Ukraine’s international activities are considered to be an important instrument in support of domestic political and economic reform with the protection of its national interests as the key objective.

Among political priorities of national development, emphasis is laid on the following:

- greater cooperation in mutual neighbour and regional security, including border issue resolution;
- Ukraine’s accession to the WTO and further integration into the European Union with the formation of the requisite legal framework for Ukraine to become an equal member of the EU;
- gradual elimination of restrictions and non-tariff barriers preventing bilateral trade, as well as pursuit of the necessary reform in this area;
- investment climate improvement by introducing a non-discriminatory and transparent business environment and streamlining of administrative procedures; and
- gradual closing of the gap between the rules and standards in Ukraine and the European Union.

The European neighbourhood policies open up new prospects for Ukraine in the fields of partnership, economic integration and cooperation as follows:

- a prospect for going beyond partnership to a considerable integration level, including participation in the EU internal market and key EU programmes;
- broadening and deepening of political cooperation;
- a chance to close the gap in economic legislations; mutual openness of economies and further reduction of trade barriers, thus encouraging investment and growth; and
- deepening of trade and economic relations, including revision of the terms and conditions for the creation of a Free Trade Area following Ukraine’s accession to the WTO.

Given that vast resources for accelerating the economic growth lie in the field of investment and any efficient market model involves, first and foremost, a private initiative based on

private property, Ukraine intends to demonstrate its inflexible will to secure reliable protection of foreign investment and offer clear, responsible and equal rules of the game for players on the Ukrainian market based on a market-driven economic philosophy and property rights in accordance with existing laws.

(For information: At a high-level international conference, *Ukraine is Looking Ahead: a Path of Reform*, on October 6, 2005, the Ukrainian Prime Minister confirmed the country's interest in the arrival of new investors at the Ukrainian market; consequently, re-privatisation in Ukraine is a closed issue and not a single effective owner will get hurt.)

1.2. Social and economic situation

1.2.1. Macroeconomics

The real growth of GDP in 2005 was 2.6% against the corresponding period a year before. During the year the economy displayed an average GDP growth with the fastest pace in January slowing down afterwards and showing a somewhat stabilising cumulative trend in September and October.

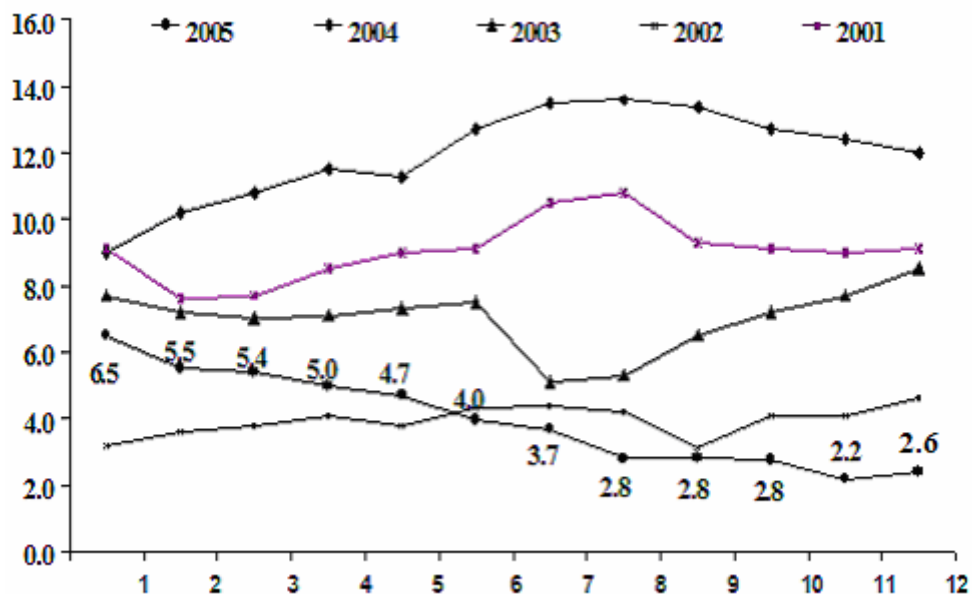


Figure 1: Cumulative percentage developments of real GDP in 2001-2005 (Source: Ukrainian State Statistics Committee)

Such downtrend was caused by a number of adverse factors.

Key internalities included the following:

- political instability in the country in late 2004 and January 2005, as well as expectations of the new team's course of action;
- reduction of budget investment expenditures in favour of social ones;
- negative expectations of investors due to uncertain ownership of privatised property, which affected contracting with non-residents.

The externalities include the following:

- a worse foreign economic environment;

- a gradual decrease in international market price levels and demand for key Ukrainian exports (e.g. metal ware) which was aggravated by a lower domestic output (due to unprofitability of some undertakings) and higher prices for primary energy.

This slowed down the growth of output in export-oriented sectors and reduced exports.

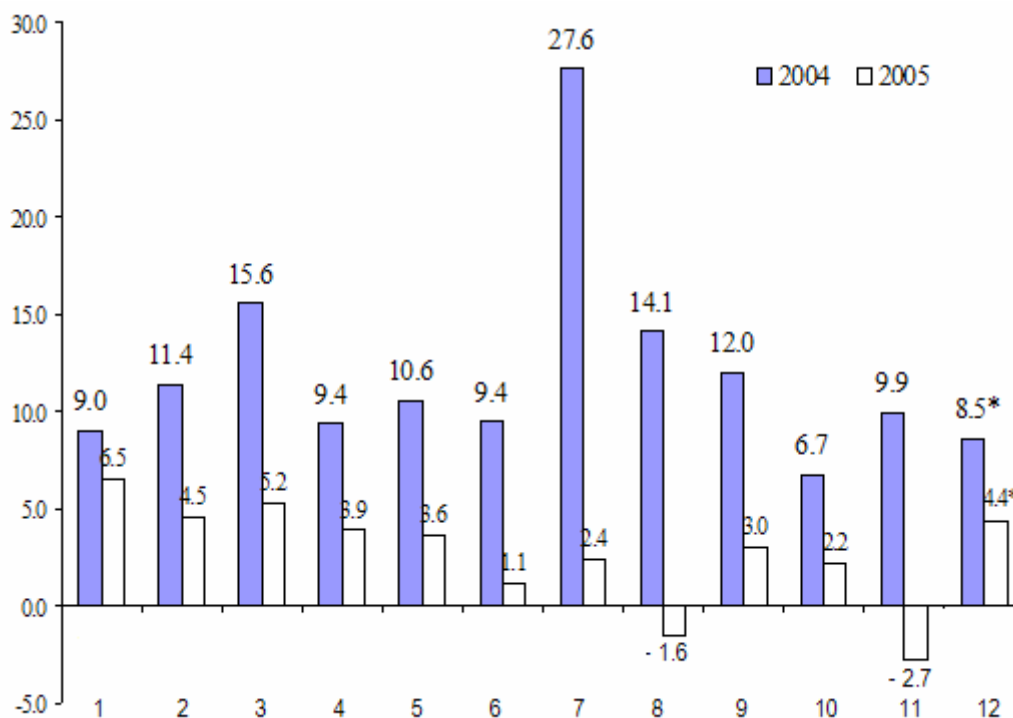


Figure 2: Real GDP developments by month versus the corresponding period a year before (Source: Ukrainian State Statistics Committee)

However, the slower economic growth in 2005 was accompanied by a drastic boost in industrial company profitability. Companies operating above the break-even point generated 17% more of profit from January to November, making a total of 65.3 billion hryvnias (USD 12.9 billion).

The higher company income was primarily achieved by combating tax minimisation schemes and a stronger administrative approach to tax collection.

Table 1: GDP metrics for 2001-2005

Metrics	2001	2002	2003	2004	2005
Economic indicators:					
- GDP, billion hryvnias	204.2	225.8	267.3	345.1	424.7
- real GDP, a.p.c.*	9.2	5.2	9.6	12.1	2.6
- Gross investment, % GDP	21.8	20.2	22.0	21.2	22.2
Foreign economic activities:					
- Export of goods and services, a.p.c.	8.0	10.7	24.0	42.6	7.5
- Import of goods and services, a.p.c.	14.1	5.0	28.7	31.3	20.4
- Current account balance, % GDP	3.7	7.5	5.8	10.6	3.1

* - annual percentage change

The consumer price index (inflation index) in 2005 equaled 110.3% (versus 112.3% in 2004). The industrial price index in 2005 stood at 109.5% (against 124.1% in 2004).

The official hryvnia gained 25.50 kopeks, or 4.81% to the US dollar during 2005, pushing the hryvnia/USD exchange rate down to 5.05 (source: Ukrainian State Treasury).

From January 2006, a GDP growth trend became discernable. Incremental GDP in February and January 2006 versus the corresponding period in the previous year was 1.5% and as high as 2.4% in March.

Incremental real GDP during the first six months of 2006 compared to the corresponding period in 2005 amounted to 5.0%

Nominal GDP as tentatively estimated for January-June 2006 equaled 206,099.0 million hryvnias.

Incremental gross value added in electricity, gas and water production and distribution totaled 5.7%.

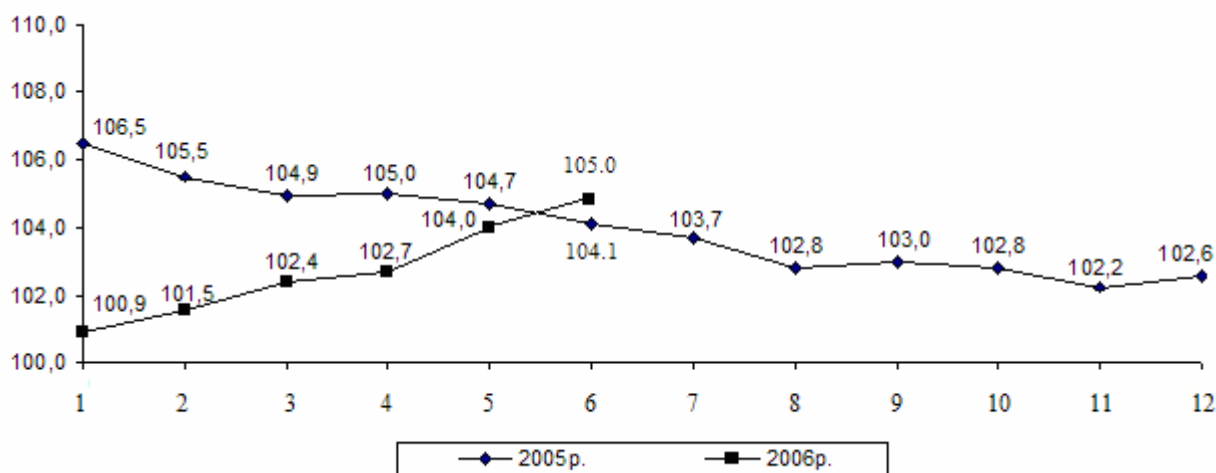


Figure 3: Real GDP percentage developments versus the corresponding period in the previous year.

The main reason for the economic pick-up was stepped-up investment: fixed asset investment in Q1 2006 was 15.9% up versus the corresponding period last year. The fast investment growth was also assisted by renewed government capital investment.

1.2.2. Foreign direct investment statistics

Between January and September 2005 foreign investors brought into the Ukrainian economy USD 1,326.6 million in direct investments while non-residents took out a total of USD 249.5 million. Aggregate foreign direct investment in Ukraine as of October 1, 2005 equaled USD 9,532.2 million (including USD 5,366.0 million worth of EU investments), with a net foreign capital gain of USD 932.2 realised in January-September 2005.

In the aggregate, in the 12 months of 2005 direct investment in Ukraine grew by 81.0% (or USD 7,328.2 million), reaching USD 16,375.2 million as of January 1, 2006.

Table 2: Foreign direct investment change in 2001-2005.

Period	FDI in Ukraine, USD mln	FDI out of Ukraine, USD mln
01.01.2001	3 875.0	170.3
01.01.2002	4 555.3	155.7
01.01.2003	5 471.8	144.3
01.01.2004	6 794.4	166.0
01.01.2005	9 047.0	198.6
01.01.2006	16 375.2	218.2
01.04.2006	17 399.2	220.7

Foreign investors brought in a total of USD 7,868.1 million in direct investment, including USD 88.9 million (1.1% of the total) from CIS countries and USD 7,779.2 million (98.9%) from elsewhere in the world. Non-residents took out USD 375.2 million.

Investments came from 118 countries with 10 of them accounting for almost 85.0% of total investment costs. Key investors in the Ukrainian economy in early 2006 included Germany with USD 5,505.5 million (33.6 %); Cyprus with USD 1,562.0 million (9.5 %); Austria with USD 1,423.6 million (8.7 %); the United States with USD 1,374.1 million (8.4 %); the United Kingdom with USD 1,155.3 million (7.1 %); Russia with USD 799.7 million (4.9 %); the Netherlands with USD 721.8 million (4.4 %); the Virgin Islands with USD 688.7 million (4.2 %); Switzerland with USD 445.9 million (2.7%); and Poland with USD 224.0 million (1.4 %).

Credit facilities and loans provided to Ukrainian undertakings by direct investors as of January 1, 2006 totaled USD 926.7 million.

Total foreign direct investment including debt capital (according to the National Bank of Ukraine) as of January 1, 2006 stood at USD 17,301.9 million.

Incremental foreign capital in Q1 2006 equaled USD 922.5 million, or 5.6% versus early in the year and 3.9 times higher than the increment in the corresponding period last year.

Credit facilities and loans provided to Ukrainian undertakings by investors as of April 1, 2006 totaled USD 1,014.9 million.

1.2.3. Economic trends in national development

The key factors of economic development this year include the following:

- higher natural gas prices for the economy as a whole and its agents, as well as higher electricity prices for households and human settlements;
- bringing minimum social guarantees closer to the poverty line;
- re-emerged trends towards gradual investment build-up;
- implementation of energy-saving policies based on the restructuring of energy production and consumption through partial reduction of energy intensive processes and development of a market environment in the fuel and energy complex

Successful corporate investment strategies and ability to draw larger debt capital and foreign investment will largely depend on domestic financial stability.

Best case scenarios provide for a real GDP growth at 4.5-5% in 2006 and 6-6.5% in 2007. Such growth rates will only be feasible if economic players promptly adapt to the new business environment (the higher gas prices) with a robust international market and a more liberal tariff policy is pursued.

Worst case scenarios have it that real GDP will fall by 1.3% in 2006 and the economic growth will resume in 2007 at 0.4%. Such scenarios forecast a gradual economic growth with higher electricity and gas prices and a weak international market (a study by the Ukrainian Economic Ministry).

Net incremental FDI in 2006 is forecast at USD 4.5 billion (taking into account the foreign investments in the banking sector to buy partial blocks of shares in Ukrainian banks).

Investment is to be boosted as a result of following:

- a better investment climate;
- introduction of energy-saving technologies;
- the need to renew companies' fixed assets;
- increased investment imports to be facilitated by the adoption of the Ukrainian Law on Amending the Ukrainian Law on the Special Regime of Technology Park Innovative Activities and Other Laws;
- improved conditions of long-term lending; and
- capitalisation of the growing personal savings through the banking system and other financial institutions.

1.3 General national energy policy

Ukraine's key energy policy tasks and priorities are defined in the Ukrainian Energy Strategy for the Period until 2030 (adopted by virtue of Ukrainian Cabinet of Ministers Resolution No. 145-p dated March 15, 2006).

Given that Ukraine is among the countries that are only partially endowed with conventional energy resources and, therefore, has to import them, as well as for lack of diversified supplies of energy such as, primarily, oil, natural gas or nuclear fuel, rational uses of conventional energy and fuels, streamlining of domestic energy production and a switch over to alternative energy sources have become of great relevance to Ukraine. All such aspects have been duly reflected in the Ukrainian Energy Strategy for the Period until 2030.

Implementing the Energy Strategy will make Ukraine an influential and active participant in international energy relations and help to consolidate the nation's energy security.

Objectives of the fuel and energy complex

Integration of the Ukrainian and European power systems is part and parcel of Ukraine's strategic objective to accede to the EU. Ukraine has relatively large and meshed gas, oil and electricity transmission networks interconnected with the transportation grids in the EU and CIS, enabling it to participate in European energy policy-making and the evolution of a

common energy market, as well as play an important role in energy cooperation between the CIS and EU.

From the perspective of global energy processes, Ukraine's favourable geopolitical and geographic position should also be taken into consideration with its related role as a transit country.

In view of such factors, it is possible to enumerate the following strategic tasks facing the fuel and energy complex (the "FEC") in the short run:

- approval of a general energy policy to facilitate moving closer to EU energy policy objectives;
- gradual changeover to the operating principles of the EU internal markets in natural gas and electricity;
- securing a high-quality and reliable energy supply;
- natural gas transit optimisation and building Ukraine's image as a reliable transit country;
- diversification of energy supplies;
- reform of the coal sector;
- energy efficiency improvements and a switch to alternative energy sources; and
- nuclear power plant safety.

Current tasks

The key tasks facing the FEC that are designed to facilitate the implementation of its strategic development areas include the following:

- compliance with the provisions of Ukrainian Law No. 2711-IV on Measures to Secure Steady Operations of the Fuel and Energy Complex, dated June 23, 2005 and intended to resolve companies' arrears for electricity supplies;
- development of a strategy for legal and technological harmonisation of the Ukrainian energy sector with the ground rules of the EU internal market;
- intensification of energy policy cooperation between Ukraine and the EU;
- further reform of electricity sector ownership forms;
- integration of the Ukrainian Interconnected Power System into the UCTE;
- rehabilitation of high voltage power transmission lines;
- infrastructure development with a view to diversify gas and oil supplies;
- continued review of financial and legal restructuring opportunities for the gas transit business;
- further reform of the coal sector;
- greater use of alternative energy sources and cooperation in implementing energy-saving projects; and
- continued work to implement an action plan at the Ukrytie facility to make Power Unit 4 environmentally clean.

2. Investment climate in Ukraine

2.1. Privatisation and ownership

Ownership optimisation and reconfiguration in accordance with a specific social and economic environment and national priorities continue on a permanent basis. International practices of European countries provide evidence to this effect.

The privatisation process underway in Ukraine is systematic and intended to build the fundamentals of a market-driven economy.

The purpose of privatisation is not just to achieve quick budget replenishments but facilitate economic restructuring through the state-of-the-art management and technology.

Following partial removal of restrictions imposed on government property privatisation, sale and alienation, the Ukrainian Government Property Fund (the “GPF”) resumed its review of demand for businesses slated for privatisation. The process is defined in a Regulation on the Review of Potential Demand for Property to be Privatised, as approved by GPF Order No. 1798 of August 30, 2000.

Property slated for privatisation is split into categories in accordance with the 2000-2002 Government Privatisation Programme approved by virtue of Ukrainian Law No. 1723-III on the Government Privatisation Programme, dated May 18, 2000.

- Category A – “small-scale” privatisation (businesses or subdivisions of businesses with headcounts of up to 100 people or more if their fixed asset value is not enough to form a charter capital of an open joint stock company);
- Category B – “large-scale” privatisation (“entire property complexes” of businesses with a headcount of more than 100 people and a sufficient fixed asset value to form a charter capital of an open joint stock company);
- Category C – “large-scale” privatisation (“entire property complex” of a business or blocks of shares in an open joint stock company that, at the time of the decision to privatise, hold a monopoly/dominant position on the domestic market or are of strategic significance to the country);
- Category D – construction in process and moth-balled facilities;
- Category E – stock (shares) held by the government in charter capitals of business entities (including those with foreign investment) located within Ukraine or abroad; and
- Category F – services sector facilities irrespective of their value.

A potential buyer becomes actively involved in the process as early as at the pre-investment stage. The pre-investment stage for Categories B and C is triggered off by filling in a questionnaire to find out if there is demand for the property. The potential buyer may indicate the preferred privatisation form in such a questionnaire. A completed questionnaire is submitted to the GPF that makes a review of the potential demand for the property and determines a method to privatise it.

The main and only form possible for “large-scale” privatisation is competitive tendering (open bidding).

Seeking to improve businesses’ efficiency and adaptation to the market environment, by its Resolution No. 41336/12/1-04 of July 18, 2005, the Ukrainian Cabinet of Ministers instructed the GPF to monitor on a continuous basis and make quarterly reports on stepped-up pre-investment activities in regard of government businesses in general and strategically important ones in particular that fall under the jurisdictions of the Ukrainian Industrial Policy Ministry, Ministry of Fuel and Energy, Transport and Communications Ministry, and Defence Ministry.

Businesses are restructured in accordance with the effective 2000-2001 Government Privatisation Programme and the Business Restructuring Regulation approved by and registered with the Ukrainian Ministry of Justice as No. 414/6702 on May 7, 2002.

Since the time the 2000-2002 Government Privatisation Programme came into force, the GPF has decided upon restructuring of 56 businesses 29 of which are of strategic significance for the national economy and security.

As of October 1, 2005, 26 businesses were under restructuring by virtue of a GPF resolution, seven of which were strategically important and eight others monopolies.

Table 3: 2003-2005 Ukraine privatisation developments by property category

Item	Period	Total	Broken down by category			
			A	B, C	D	E
Number of property units	2003	6546	5881	39	475	151
	2004	6155	5609	40	338	168
	2005	5664	5263	11	289	101
Expected cash receipts from sale of property, mln hryvnias	2003	859.3	796.8	1.8	37.3	23.4
	2004	1055.5	976.6	16.3	32.8	29.8
	2005	1042.3	956.7	-	55.2	30.4

(Source: Ukrainian Statistics Committee)

In the aggregate, according to the GPF, 890 units of government property changed ownership forms in Ukraine in the 12 months of 2005 as follows: Category A – 549 (61.7 %); Category B – 11 (1.2 %); Category Д – 234 (26,3 %); Category E – 19 (2,1 %); and Category Ж – 77 (8.7 %) (to be compared with the 2004 data: 1,236 units: A – 774 (62.6 %); B & C – 38 (3.1 %); D – 264 (21.4 %); E – 37 (3.0 %); and F – 123 (9.9%)).

The key privatisation methods included buy-out (395 property units) and auctioning (421 units) (or 44.4% and 47.3% of the total, respectively). Fifty nine (6.7%) property units were purchased through leasing, seven (0.8%) by repurchase of OJSC shares, four (0.4%) through noncommercial tenders and four others (0.4%) through commercial tenders.

During the reporting period, 184 (90.2%) blocks of Category B shares, 18 (8.8%) Category Г property units and two (1%) Category E property units were traded for cash at Ukrainian stock exchanges and in the First Stock Trading System for a total value of 1,067.99 million hryvnias (USD 211.48 million).

Aggregate revenues from privatisation in 2005 amounted to 20.71 billion hryvnias (USD 4.1 billion).

Table 4: Number of open joint stock companies by privatised property percentage

As of	Number of JSC	JSC privatised property percentage			
		Through 49.9%	From 50.0% through 69.9%	From 70.0% through 99.9%	100%
01.01.2002	2045	18.8	11.4	54.7	15.1
01.01.2003	1567	20.5	12.4	56.4	10.7
01.01.2004	1322	18.0	13.2	49.3	19.5
01.01.2005	1089	20.3	12.8	43.6	23.3
01.01.2006	794	24.3	14.0	51.9	9.8

(Source: Ukrainian Statistics Committee)

Pursuant to Ukrainian Government and Supreme Rada instructions, the GPF came up with a Draft Law on the Government Privatisation Programme (No. 3172; registration date: July 2, 2003) envisaging introduction of a 2005-2007 Government Privatisation Programme and a Draft Law Amending Certain Privatisation Laws (No. 1059; registration date: May 22, 2002), which were intended to improve the legislation and harmonise the legal framework in the field of privatisation.

The main task defined in the Draft Privatisation Programme includes raising the efficiency of the public sector through optimised asset structure. To make businesses more competitive, the bill provides for a broad range of sale mechanisms including auctioning, competitive tendering, open bidding and securities trading

In addition, the Draft Programme specifies government property privatisation mechanisms differentiated for each property category.

For the purpose of legislative protection of shareholder rights, including those of the government as shareholder, the GPF participated in the drafting of a Ukrainian Law on Amending Certain Ukrainian Legislative Acts (in regard of the government's "golden share" right). The bill envisions granting a special "golden share" right to the government enabling it to participate on a compulsory basis in the management of companies that are strategically important for the national economy and security.

According to the GPF press service, there are plans to generate about 6.0 billion hryvnias (app. USD 1.2 billion) from government property privatisation in 2006.

Between January and May 2006, 258 government property units in Ukraine changed hands, broken down as follows: Category A – 127 (49.2 %), Category B – 6 (2.3 %), Category Д – 105 (40.7 %), Category E – 2 (0.8%), Category Ж – 18 (7.0 %). According to a GPF update, government property privatisation and other related revenues amounted to 164.15 million hryvnias.

As to energy companies' debt, today it may be resolved through the compliance with Ukrainian Law No. 2711-IV on Measures to Secure Steady Operations of the Fuel and Energy Complex, dated June 23, 2005 and effective from July 26, 2005. The Law specifies a

range of organisational and economic measures to ensure both steady energy company operations and financial revitalisation of the state as a whole.

In September 2005, Energorynok, a government company, set up a subdivision, Clearing House, with authority to maintain a register of energy companies that participate in the debt repayment process and coordinate those involved in such settlements.

Pursuant to the said Law, subject to repayment is debt (both receivables and payables) incurred as a result of underpayment for energy prior to the designated date – January 1, 2005 – and remains outstanding on the settlement date.

The Ukrainian Ministry of Fuel and Energy approved a list of energy companies that decided to participate in the debt repayment process. The list includes 440 companies (70 electricity companies, 52 oil and gas companies, 98 coal companies, and 220 district heating companies).

Implementing the debt repayment mechanism and preventing any new debt will drastically improve the investment attractiveness of energy companies, considerably enhance their financial results and help to resume privatisation in the sector.

2.2. Taxation

2.2.1. Tax Code

In the past few years, Ukraine has seen tax legislation changes contributing to the improvement of the investment climate in the country. In particular, under the new Tax Code (No. 0935 dated May 14, 2002; currently reviewed by Supreme Rada committees), a new profit tax rate at 25% has been in effect since January 1, 2004 in accordance with Ukrainian Law No. 349-IV of December 24, 2002 on Amending the Ukrainian Corporate Profit Tax Law.

The lower profit tax rate allowed companies to obtain an additional source of working capital that they may use at their discretion to satisfy their own requirements such as new technology introduction, capacity upgrading, foreign trade development, greater domestic supplies of goods and services, and the creation of modern industrial, transportation and market infrastructures.

Given that the profit tax is the core budget building element, the profit tax rate reduction was accompanied by a tax base enlargement. In particular, from 2004 to March 2005 government-owned companies paid 15% of net profit on a quarterly basis and based on their yearly financial and business results, while effective from March 2005 the share of profits increased to 50%.

To maintain the investment capability of government-owned companies, in particular those in the electricity sector, Ukrainian Cabinet of Ministers Decrees No. 558 of April 22, 2003, No. 405 of March 30, 2004 and No. 50 of January 15, 2005, exempted from government budget contributions that part of profit/income generated by energy companies subject to government regulation of prices and tariffs (Energoatom, Energorynok, Ukrenergo), which they use to implement government industry programmes, secure government guarantee obligations, complete power units and enhance their safety.

Such benefits are intended to contribute to adequate funding of such activities and stable operations of the integrated power system.

It should also be noted that by virtue of Ukrainian Law No. 2181-III on Repayment of Taxpayer Liability to Budgets and Special Purpose Government Funds, coal companies wrote off tax assessments amounting to 601.1 million hryvnias (about USD 112 million) which were beyond the statute of limitations time in 2003-2004.

The new Ukrainian Tax Code will allow for a system of taxation with a rational mix of direct and indirect taxes and reduce the number of taxes, thus increasing the efficiency of the tax system in general. To enable an environment encouraging investment and innovation, the taxpayer will have the right to reduce the tax base by the amount used for reinvestment.

The Code envisages including in the profit taxpayer category legal entities (both Ukrainian residents and non-residents) as well as permanent representatives of Ukrainian non-residents, except for those Ukrainian non-residents who have a diplomatic status in accordance with Ukraine's international agreements and existing laws.

The adoption of the new Tax Code incorporating EU recommendation will enable a more efficient protection of both taxpayer and state interests and expedite integration of Ukrainian laws into the European system of law.

2.2.2. Civil Code

The new Ukrainian Civil Code came into force on January 1, 2004 (Ukrainian Law No. 435-IV dated January 16, 2003).

Ukrainian Law No. 2631-IV of June 2, 2005, on Amending Selected Legislative Acts of Ukraine to Make the Legislation Conform to the Ukrainian Civil Code amended, *inter alia*, Article 9 of the Ukrainian Law on Repayment of Taxpayer Liability to Budgets and Special Purpose Government Funds, which should benefit the tax system.

In accordance with such amendments:

- Article 9.3.1(a) was deleted which provided that the head of a tax authority (or his/her deputy) may decide upon attachment of taxpayer assets, which decision shall be forwarded to the banks serving the taxpayer with the requirement that withdrawals of funds from such taxpayer's accounts be suspended (if the taxpayer is a bank, with the requirement that withdrawals of funds from its own accounts be suspended);
- Article 9.3.9 was added to the effect that attachment of assets in the form of suspending transactions in the taxpayer's account shall only be based on a court ruling and shall be made in the manner prescribed by the law;
- Article 9.4.1 stipulates that execution of a taxpayer asset attachment determination (except for attachment in the form of suspending transactions in the account) shall be the responsibility of a tax executive or another employee of the tax authority appointed by its head (or his/her deputy).

Structurally, the new Civil Code includes six books:

- general civil law provisions;
- non-property rights;
- ownership and other proprietary interests;

- intellectual property rights;
- liability; and
- law of inheritance

The following hierarchy of legislative acts was established for the first time to apply to civil relationships:

- 1) the Constitution;
- 2) the Civil Code;
- 3) Ukrainian Laws;
- 4) Presidential Acts;
- 5) Cabinet of Ministers Decrees; and
- 6) state authority acts.

International agreements play a special role in the hierarchy and given the highest priority. Therefore, Civil Code rules may also extend to labour relationships; agreements may be entered into which are not provided for in legislative acts but which are compliant with the Ukrainian Civil Code.

2.3. Attraction of foreign investment

The pace of capital investment increments in recent years (31.3% in 2003; 28.0% in 2004) has served a relatively good basis for a tangible acceleration of investment inflow into the public sector of the economy.

In 2005, capital investment growth dropped to 8.5%. For the first time in the past seven years construction shrank, too (92.3% in January-June 2005). In this connection, it should be emphasised that the quality of investment is no less important than its scale.

Despite the dramatic slowdown of GDP growth in 2005, the Ukrainian economy retains a relatively robust potential.

The key government objective to improve the investment climate in Ukraine, achieve a steady high GDP growth and establish a constructive dialogue between the authorities and investors includes economic diversification and consolidation by reducing business transaction costs and laying the groundwork for deeper trade integration.

This will be achieved by means of:

- 1) business deregulation and reliable protection of private property (measures are being implemented to drastically simplify business organisation and increase the number of activities to be conducted without permits or licenses);
- 2) securing stability of the legislative framework;
- 3) continued regulation reform and liberalised tax control of business entities;
- 4) improved corporate governance and protection of shareholder rights;
- 5) demonopolisation of individual economic sectors, continued liberalisation of goods and capital movements across the border;
- 6) financial sector strengthening;
- 7) adoption of a strategic action plan for further property transformation and greater involvement of the private sector in all economic spheres; and

- 8) harmonisation of the Ukrainian energy sector with the key EU internal energy market rules.

Such measures are slated for implementation before yearend 2006 as part of a development policy support loan project of the International Bank for Reconstruction and Development (the intent of the Ukrainian party is described in the Government letter to the IBRD on the development policy).

For the purpose of achieving legislative and institutional shifts towards the creation of reliable investor right protection mechanisms and a positive turnaround in terms of foreign business attitude to the Ukrainian economy in accordance with Ukrainian President Decree No. 625 of April 11, 2005, the composition of the Advisory Board for Foreign Investment in Ukraine was reinstated and a relevant Expert Commission formed.

On July 19, 2005, the President of Ukraine issued Decree No. 1116 on Measures to Improve Investment and Innovative Activities in Ukraine with a view to set up a National Council of Ukraine for Investment and Innovation with the key objective to facilitate the development and pursuit of a single government policy for investment and innovative activities in Ukraine, as well as coordinate government authorities and public institutions in this area.

Seeking to create a clearer legal and institutional environment for foreign investor operations in accordance with UCM Decree No. 666 of August 2, 2005, a Ukrainian Centre for Encouraging Foreign Investment and Government Resolution No. 303 of August 2, 2005 approved the membership of its Supervisory Board.

To simplify the permitting process for business entities, the Supreme Rada of Ukraine passed Ukrainian Law No. 2806-IV of September 6, 2005 on the Business Permitting System as the first step towards a sweeping reform of the permitting system. The said regulatory document envisages measures to improve the government/business relationship framework, harmonise Ukrainian business laws with applicable European legislation. An important innovation is that business permits may now be obtained by declaration.

Based on the deliberations of the Advisory Board for Foreign Investment in Ukraine at the end of 2005, the Ukrainian President issued Decree No. 1513 on Measures to Improve the Investment Climate in Ukraine, dated October 28, 2005, and Decree No. 300 on the Investment Priority Action Plan, dated April 10, 2006. Such documents provide for the drafting of a law to encourage innovation and proposals relating to investor compensatory mechanisms in free trade areas, intensify concessions, introduce a summary process for investment project land allocations and help to remove barriers to investment.

With a view to formalize inhouse assigns' stay in Ukraine in the case of businesses with foreign investment, the UCM issued a Decree Amending Para. 7 of the Regulation on Work Permit Issuance to Foreigners and Stateless Persons to provide for work permit issuance to "inhouse assigns" (executives, managers and specialists) and persons performing services without commercial presence in Ukraine for the term of employment rather than one year at most as in the case of other employee groups.

To improve legal regulation in corporate governance, a Ukrainian Draft Law on Joint Stock Companies (Registration No. 8326 of October 21, 2005) has been submitted for review to Ukrainian Supreme Rada committees. The bill seeks to resolve controversies and improve legal control of joint stock companies.

There are plans to adopt a Ukrainian Law Amending the Ukrainian Law on Joint Investment Institutions (Mutual and Corporate Investment Funds) to improve diversification of joint investment assets and incorporate the alterations called for by the adoption of the Ukrainian Civil Code. If passed, the Law would help draw more investment resources into the Ukrainian economy (to be adopted and enacted in 2007).

2.4. Exclusions from national treatment of foreign investors

As of January 1, 2006, Ukraine maintains six items in the register of exclusions from national treatment of foreign investors. The main exclusion still applies to the right to use land resources.

In view of the government policy of liberalising land relationships and the desire to encourage and liberalise foreign investment in all sectors of the national economy, this specific exclusion is slated for gradual relaxation.

In particular, pursuant to Ukrainian Law No. 1103-IV of July 10, 2003, Article 82 of the Ukrainian Land Code was supplemented with Part 3 which has it that title to non-farm lands may also be given to joint ventures involving foreign individuals or legal entities.

A positive development in this area includes a rule provided for in Ukrainian Law No. 3235 on the 2006 Government Budget of Ukraine, dated December 20, 2005, which amends the Ukrainian Land Code and Ukrainian Law No. 2163-XII of March 4, 1992 on Government Property Privatisation. In accordance with such regulatory document, land plots underlying property to be privatised will be sold to the investor in 2006 on a compulsory basis. The Ukrainian Law on the 2006 Government Budget of Ukraine also amends Article 129 of the Land Code, governing the sale of government or public lands to foreign states and foreign legal entities (nowadays, such land sales are effected by government privatisation authorities per UCM instructions and in agreement with Supreme Rada of Ukraine).

Such amendments are expected to make a positive impact on land market development and provide prospective investors with a greater opportunity in the use of the privatised property. In addition, such rules seek to expedite the completion of the land market in Ukraine and draw investment in real property.

Privatisation has also undergone certain change. A Regulation on Tendering for the Sale of Joint Stock Company Blocks of Shares as approved by GPF Order No. 1800 of August 31, 2004 and registered with the Ukrainian Ministry of Justice as No. 1634/10233 on December 23, 2004, has settled matters relating to foreign investor participation in tenders.

In addition, UCM Decree No. 617 of May 11, 2006 repealed UCM Decree No. 853, Approving the Procedure for Foreign Business Entity Transactions Involving Products of Ukrainian Origin within Ukraine without Taking Them out of the Ukrainian Customs Territory, dated July 30, 1996.

The Ukrainian Government policy of liberalising treatment of foreign investors is further evidenced by the adoption of, *inter alia*, Ukrainian Law No. 3042-IV of November 2, 2005, Ratifying the Protocol between the Ukrainian Cabinet of Ministers and the Government of the Republic of Belarus on Phasing out Exclusions from Free Trade, and Ukrainian Law No. 3195-IV of December 14, 2005, Ratifying the Protocol on Amending the Agreement between

the Government of Ukraine and the Government of the Republic of Uzbekistan on Free Trade, Dated December 29, 1994.

3. Energy sector structure and prospects

3.1. Electricity sector

3.1.1. Change of output

The corner stone of the Ukrainian electricity sector is the Interconnected Power System (IPS) of Ukraine that secures centralised power supply of domestic users and interconnects with the power grids of adjacent countries to allow for electricity export, import and transit. It includes generating capacities and distribution grids in Ukrainian regions which are interconnected through 220-750 kV backbone power supply lines. Ukrenergo, a government company, is responsible for dispatching control of the IPS and its operation modes and ensures reliability and parallel operations with power systems in other countries.

The aggregate generating capacity in 2005 equaled 52.0 million kW with thermal power plants (TPP) and combined heat and power (CHP) accounting for 57.8%, nuclear power plants (NPP) for 26.6%, hydro power plants (HPP) and pump storage plants (PSP) for 9.1%, isolated generating plants and other sources for 6.5%.

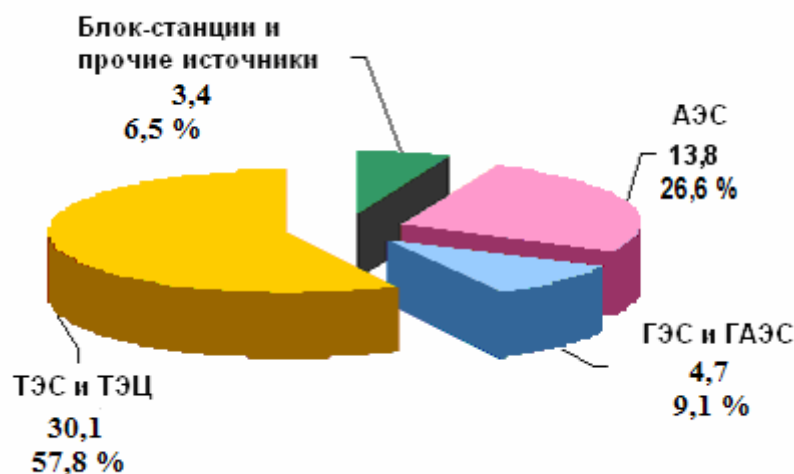


Figure 4: Aggregate generating capacity of the IPS Ukraine in 2005

NPP's bear the brunt of power generation in Ukraine (about 50%). The TPP and HPP shares equal app. 40% and 7%, respectively. Isolated generating plants and CHP that do not fall into the jurisdiction of the Ukrainian Ministry of Fuel and Energy account for no more than 5% of power generation.

Total net power consumption by businesses and households in 2005 grew by 2,783.4 million kWh (or 2.1%) against 2004, reaching 151,849 million kWh.

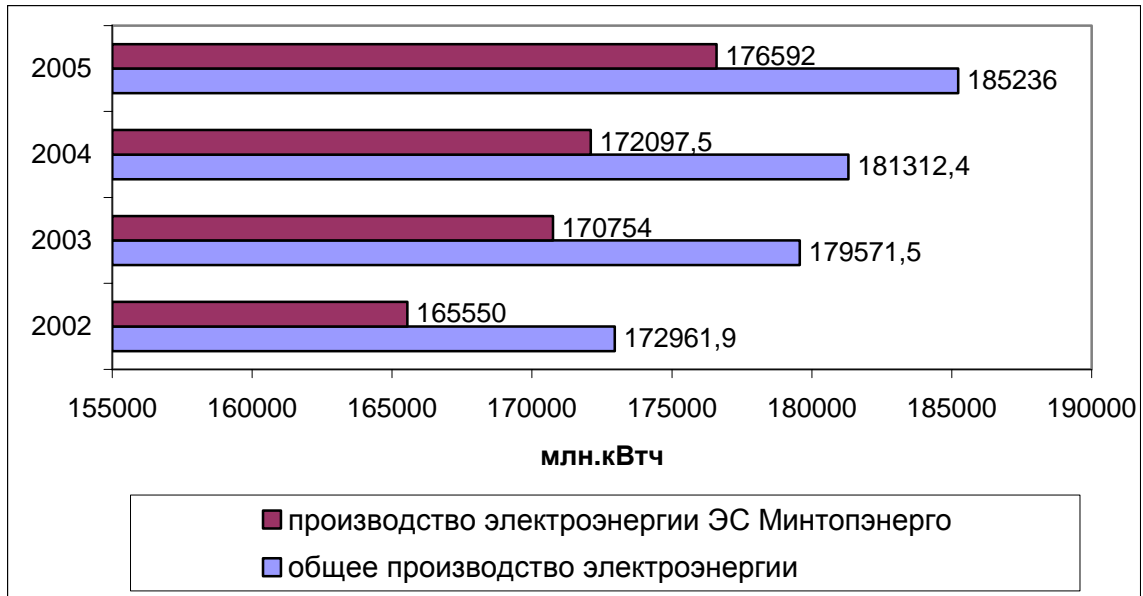


Figure 5: Electricity generation developments in 2002-2005

[Legend: - red - Electricity generated by power plants under the jurisdiction of Ministry of Fuel and Energy; Blue - Total generation]

According to an update, in January-June 2006 IPS electricity generation totaled 96,634.5 million kWh, an increase by 1,570.7 million kWh (1.7%) versus the corresponding period in 2005. Net power consumption by businesses for the same period was also up, equalling 72,261.9 million kWh, an increase by 2,563.6 million kWh compared to the same period last year.

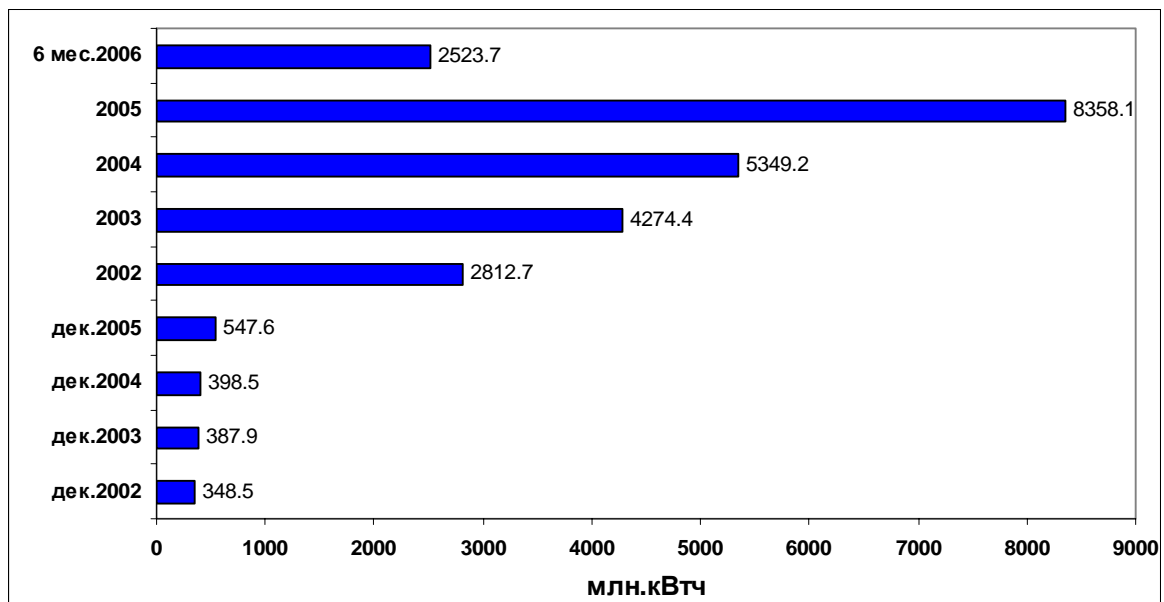


Figure 6: Development of electricity exports to Central and Eastern Europe

In December 2005, 547.6 million kWh was exported – 21.4% up against the corresponding period in 2004, with total exports in 2005 exceeding the 2004 number by 56.3%.

The increase resulted chiefly from electricity exports to the Russian Federation which started from December 1, 2004, amounting to 2,829.1 million kWh in the first six months of 2005.

However, exports to Russia have been frozen since July 1, 2005 until the price for electricity is finally agreed.

In the first six months of 2006 electricity exports totaled 2,523.7 million kWh, rising by 253.9 million kWh (11.2%) versus the first six months in 2005.

In 2005, Ukrainian NPP's operated 15 power units with a total installed capacity of 13,835 MW. During 2002-2005, the nuclear power sector succeeded in maintaining incremental outputs.

Electricity supplied to the energy market amounted to:

2002	73,249 million kWh
2003	76,700 million kWh
2004	81,834 million kWh
2005	83,312 million kWh

3.1.2. Financial performance and sectoral reform

The wholesale electricity market (WEM) in Ukraine operates as a single buyer market. For a long time, WEM operations – just like those of the entire energy sector – have been unsteady largely due to non-payments and accumulated arrears for electricity supplies. Commencing in 2000, there has been a strong tendency towards full payments for electricity supplied.

The resolution of non-payments allowed the industry to plan for a transition from the single-buyer market to a more efficient and customer-oriented electricity market pattern. By its Decree No. 1789 of November 16, 2002, the Ukrainian Cabinet of Ministers approved a Concept of Ukrainian Wholesale Electricity Market Operations and Development (the "Concept") which provides for a stage-by-stage transition from the existing WEM pattern to a full-scale competitive market in electricity with bilateral contracts and a balancing arrangement enabling the uncontracted electricity demand/supply equilibrium.

The Concept envisages three transition phases towards a complete and competitive market:

- 1) fuller use of the existing WEM pattern potential and setting the stage for the transition to a bilateral contract market;
- 2) progressive introduction of bilateral contracts and a balancing market with parallel operations of the old and the new market patterns; and
- 3) introduction of the complete bilateral contract market and the balancing market, as well as appropriate monitoring arrangements.

With a view to implement the Concept, UCM Decree No. 328 of March 17, 2004, appointed an Inter-Departmental Commission to coordinate the implementation of the Concept of Ukrainian Wholesale Electricity Market Operations and Development. By Protocol No. 17 of December 27, 2005, an action plan was adopted to secure implementation of the Concept (Phase 2: mid-term activities for 2006-2008).

The estimated time for completion of the Concept is no longer than five years.

The amendments to existing laws have considerably reduced the potential for electricity consumption free of charge. For example, the Ukrainian Law on the 2005 Government Budget of Ukraine approved a list of secured tax items that provide for allocation of funds to

pay public sector entity electricity bills, determined source of grant-in-aid, subsidies and benefits relating to payments for electricity, while the Ukrainian Law on Measures to Secure Steady Operations of the Fuel and Energy Complex included a mechanism to repay existing company arrears.

In addition, the commissioning of two NPP power units helped to stabilise the wholesale market price level.

According to Energorynok, measures implemented in January-December 2005 enabled an electricity bill collection rate of 99.1%, a 3.1% increase compared to 2004. The value of Energorynok generator supplied electricity went up by 3,413.4 hryvnias (or 16.8%), with payments for it exceeding the corresponding period in 2004 by 4,015.7 million hryvnias (or 16.8%).

The total IPS collection rate for NPP electricity equaled 98.7%.

The positive trend towards full payment of electricity and heat bills continued into 2006. Actual collection in the first six months of 2006 was 96.3% and 96.6% for electricity, 3,537.2 million hryvnias more than for the corresponding period last year.

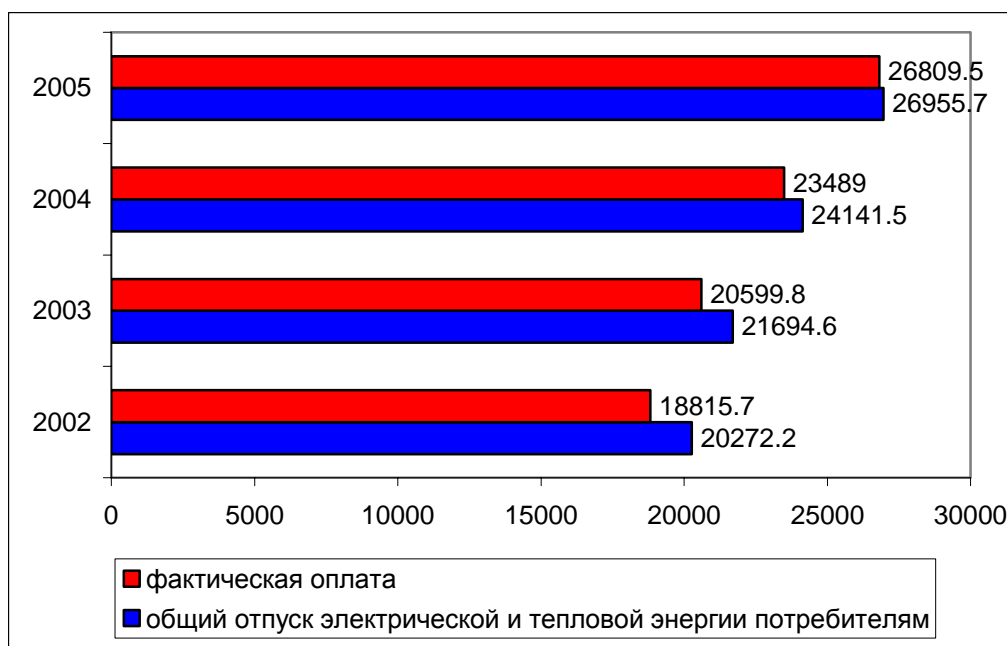
The key problem preventing full collection in the electricity section is that it is possible for water supply and water disposal companies to use power free of charge, with its resolution requiring amendment of the Ukrainian Law on Potable Water and Potable Water Supply.

A critical issue which, if unresolved, precludes the transition to the bilateral contract market is cross-subsidising between different consumer groups. Although cross-subsidies between non-household users have been discontinued, subsidising of households for the account of other consumer groups continues.

To implement measures designed to promote competition on the wholesale electricity market and eliminate administrative intervention with its operation, amendments have been adopted to the Ukrainian Law on the Electricity Sector (No. 2362-IV of January 18, 2005) to provide for prorated payments for electricity supplies, as well as amendments to the WEM Rules to promote competition on the market.

Summing up, it may be stated that the first phase of Concept implementation has secured the key institutional and economic environment for the gradual introduction of bilateral electricity contracts between the generator and customer. The residual problems may be resolved during the second phase which begins in 2006 subject to adequate resources and advisory support provided to the Concept implementation process.

The adoption of Ukrainian Law No. 2711 of June 23, 2005 on Measures to Secure Steady Operations of the Fuel and Energy Complex provided an impetus to improving the financial status of sectoral companies and helped to take a number of steps to prevent their bankruptcy. Implementation of the mechanisms set forth in the Law is expected to resolve company arrears and facilitate the resumption of privatisation processes and efficient operation of energy companies.



[Legend: - Red -Actual payments; Blue - Total supply of power and heat to customers]

Figure 7: Heat and power bill payment statistics

The said regulatory document enabled sectoral companies to:

- 1) make mutual settlements to repay debt incurred prior to January 1, 2005 for a total of 448.8 million hryvnias (USD 88.9 million), and execute agreements for payment of 370.0 million hryvnias (USD 73.3 million);
- 2) write off 473.4 million hryvnias (USD 93.8 million) in late payment interest, penalty and financial sanction accruals on the tax arrears;
- 3) restructure tax principal amounting to 277.5 million hryvnias (USD 55.0 million) for a period of 10 years; and
- 4) write off 92.2 million hryvnias (USD 18.3 million) in selected types of energy user debt (public sector entities, households, benefits and subsidies, wound-up businesses); in addition, preparations are nearing completion for an Inter-Departmental Commission review of documents to write off more than 305.0 million hryvnias (USD 60.4 million)

Between January 1, 2005 and July 1, 2006, energy supply company debt to the wholesaler amounting to app. 1,500.0 million hryvnias (USD 297.0 million) was also repaid.

The timeline for the measures provided for in the Law are slated for extension to January 1, 2007 such that the potential of such regulatory mechanisms may be fully used.

Removal of barriers to property relationship reform in the energy sector will boost the privatisation process.

Pursuant to Ukraine President Decree No 69 on Measures to Improve Efficiency of Electricity Sector Management, dated January 22, 2004, by Decree No. 794 of the Ukrainian Cabinet of Ministers, dated June 22, 2004, a National Joint Stock Company was formed, Electrical Company of Ukraine. Transferred to the charter capital of the company were the government held blocks of shares of the following entities: Dneproenergo, Donbassenergo, Zapadenergo, DEK Tsentrenergo, Donetskoblenergo, EK Zakarpatyoblenergo, Zaporozhoblenergo, AL Kievenenergo, Krymenergo, Lvovoblenergo, Luganskoblenergo, EK

Nikolaevoblenergo, EK Odessaoblenergo, Poltavaoblenergo, Prikarpatyeoblenergo, Sumyoblenergo, Ternopoloblenergo, AK Kharkovoblenergo, EK Khmel'nitskoblenergo, Cherkassyoblenergo, EK Chernovtsyoblenergo, EK Chernigovoblenergo, and Dnestrovskaya PSP. The company's only shareholder includes the government represented by the Ukrainian Ministry of Fuel and Energy. The charter capital of the company may be only be changed by resolution of the Ministry of Fuel and Energy in agreement with the Ukrainian Cabinet of Ministers.

(For information: shareholders of government-owned "oblenergos" (regional electrical companies) include foreign companies as well. For example, V.S. Energy Int. N.V. (Slovakia/Netherlands) holds 21.97 of shares in EK Chernovtsyoblenergo, 20.36% in EK Odessaoblenergo, 11.78% in EK Khmel'nitskoblenergo, and 10.53% in Zakarpatyeoblenergo. The company controls 95.18% of shares in Sevastopolenergo, 94.51% in Khersonoblenergo, 94% in Krovogradoblenergo, and 91.6% in Zhitomiroblenergo.)

The Ukrainian Government Property Fund considers selling government-held shares in three Category Г property units: OJSC Prikarpatyeoblenergo, OJSC Chernigovoblenergo and OJST Lvovoblenergo. Government equity interests in such companies are 25.02 %, 25.00 % и 26.98 %, respectively. Such companies have been slated for privatisation in 2006.

In 2004, Prikarpatyeoblenergo was included in the list of companies of strategic significance to the national economy and security and considered to be a major taxpayer contributing to government budgets at all levels. The company steadily builds up electricity supplies to customers (1,431 million kWh in 2002, 1,654 million kWh in 2003, and 1,860 million kWh in 2004) and is the electricity transmission and supply monopoly in the City of Ivano-Frankovsk and Ivano-Frankovsk Oblast. Customer payments for electricity supplies during the reporting period amounted to 101.1%.

OJSC Energy Company Chernigovoblenergo is the legal successor to the Government Company Chenigovoblenergo formed from unbundled subdivisions of Kievenergo and the regional electricity controlling agency located in Chernigov Region. The company is the monopolistic supplier of electricity to customers in Chernigov Region. It has substations and power supply lines with voltages ranging from 0.4 kV to 110 kV. In addition, it includes two high voltage grid companies – Severnoye and Yuzhnoye – which transmit electricity with voltages from 35 to 110 kV. Chernigovoblenergo controls Chernigov CHP. A block of shares in the company, which is close to the controlling one, is held by an offshore company group. OJSC Lvovoblenergo is the monopolistic distributor of heat and power in Lvov Region with very stable performance. Total length of the power grid equals 38.6 km. The company supplies electricity to more than 817,000 customers. In 2004, the company grid received 4,088.398 million kWh. All electricity is purchased from Energorynok. Payments amounted to 106.15%. The shareholder composition is as follows: strategic investors (60.82%), private investors (5.76%), and staff (6.02%).

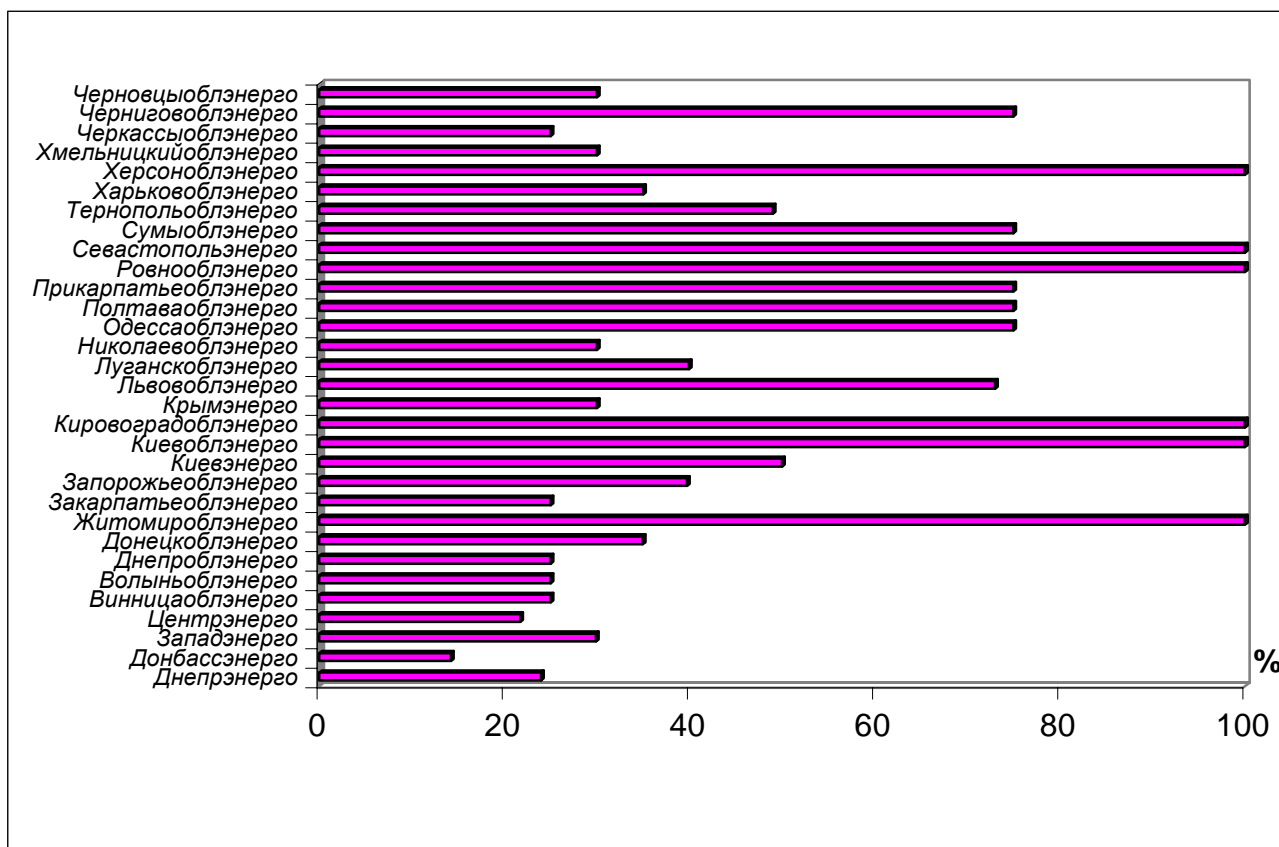


Figure 8: Regional electricity company privatisation profiles

After the energy sector payables are resolved including those of regional electricity companies slated for privatisation, the GPF will value their share blocks and following approval by the Ukrainian Cabinet of Ministers, a tender date will be announced for the potential property to be sold.

3.1.2. Interconnected Power System of Ukraine: realities and prospects

Following collapse of the USSR, the power systems in the Russian Federation and Ukraine continued to operate synchronously (in parallel) as part of a single energy association. The Ukrainian Ministry of Energy and Electrification and respective Ministers of Russia (1992), Belarus (1992) and Moldova (1995) concluded agreements on securing parallel operations of power systems.

At Russia's request, parallel operations of the Russian and the Ukrainian power systems was discontinued on November 27, 1999, because it was impossible to control minimum (zero) net power flows in the absence of commercial supplies. By then the Ukrainian IPS had already operated separately from the Belarus IPS. Power exchanges with the Unified Energy System (UES) of Russia amounting up to 1 million kWh continued only through dead-end lines to border area loads that traditionally used power from the adjacent power system only, with no supplies under foreign trade contracts.

Parallel operations of the Ukrainian IPS with the Moldova Power System are in effect compulsory for Ukraine because power to Odessa and the south-western part of Odessa Region is supplied from the Moldova Power System. Power supplies to the Moldova Power System prior to January 1, 1999, were shown as unscheduled. To date, Moldtranselectro (the successor to Moldenergo) is still in debt to Energorynok for uncompensated net power flow from the Ukrainian IPS amounting to 50 million kWh consumed by the Moldova PS in October 1998.

Discontinued parallel operations with the Russian UES and shutdown of the last unit of the Chernobyl NPP (in 2000) led to a situation where the Ukrainian IPS had to operate in nearly emergency modes with frequencies at the verge of the allowable minimum/bare minimum.

The Ukrainian energy sector is faced with a global task of pulling the power industry out of the crisis, establishing steady transparent and mutually advantageous contractual relationships, and reinstating parallel operations with adjacent power systems to secure their reliability and develop the national export capability. Given that a Customs Control and Customs Processing Procedure for Electricity Transmitted across the Customs Border of Ukraine through Power Transmission Lines came into force in January 1999, all electricity became subject to compulsory customs control and processing.

Ukraine's electricity export/import schematic is described below:

Ukrainian IPS – Russian UES

Before the resumption of parallel operations of the power systems in Russia and Ukraine, Energorynok imported electricity from the Russian UES (Russian JSC “UES Rossii”) for Ukrainian border area customers (mines) through dead-end high voltage lines. The settlements were 100% in cash (hard currency).

At the meeting of the Russian and the Ukrainian Presidents in February 2001, a Memorandum on Electricity Sector Cooperation was signed between the Ukrainian Ministry of Fuel and Energy (S.F. Yermilov) and UES Rossii (A.B. Chubais) stating that the RF and Ukrainian power systems were to resume parallel operations based on documents that governed relations between the parties.

Also in February 2001, Energorynok and UES Rossii entered into contracts for purchase/sale of net power flows.

In April 2001, the Ukrainian Cabinet of Ministers decided upon the Ukrainian IPS commencing parallel operations with UES Rossii based on contract between Energorynok and UES Rossii, which decision was reflected in the April 4, 2001 Decree of Ukrainian Cabinet of Ministers.

In August 2001, following a number of technical and organisational measures, the Ukrainian IPS and Russian UES resumed parallel operations. The contracts between Energorynok and UES Rossii for purchase and sale of net power flows came into force. Settlements are 100% in cash.

Pursuant to the protocol resolutions by the Ukrainian Cabinet of Ministers and UES Rossii (2001-2002), effective April 1, 2002 electricity supplies commenced from the Russian UES

to the Moldova Power System transiting through the power grids of the Ukrainian IPS, with such supplies being made as part of joint Russian-Ukrainian deliveries into the Moldova power system of a parity basis. A Ukrainian operator has been designated for transit of Russian electricity (GPVD Ukrinterenergo). Energorynok contracted with Ukrinterenergo for electricity purchases to make up for losses caused by Russian electricity transit.

Commencing in December 2004, Energorynok started WEM base load sales to Energoatom for export to the Russian Federation (up to 500 kWh monthly). Electricity sales followed a smooth-running hourly schedule through June 2005.

Ukrainian IPS – Moldova Power System

In January-September 1999, Ukrenergo (represented by SOP Energorynok) started electricity sales to operators for export to the Moldova power system. Settlements were to be by mutual setoffs.

In October 2000, Energorynok began direct electricity exports to the Moldova power system based on foreign trade contracts. Settlements were to be 100% cash.

Between November 2000 and October 2002, Energorynok sold electricity to Itera Ukraina for exports to the Moldova PS. Settlements were to be 100% cash.

Since November 2002, Energorynok has sold electricity to Ukrinterenergo for export to the Moldova PS. Settlements are 100% cash.

Ukrainian IPS – Belarus IPS

In June 2005, a commercial contract for electricity exports was entered into and took effect between Energorynok and the Belenergo Concern, under the terms of which high voltage interconnectors VL-330 kV were tested between the Ukrainian IPS and Belarus IPS in June 2005. A total of 2.55 million kWh was supplied to the Belarus IPS.

In June 2005, commercial contracts of sale were executed for electricity supplied to border area customers through dead-end power lines.

An important export capacity building event for the domestic electricity sector was the beginning of parallel operations of the so called “Burshtynsky TPP Island” with the UCTE power systems.

The Burshtynsky TPP Island covers Western Ukraine with an area of 27,000 km² and a population of about 3 million inhabitants. It includes the Trans-Carpathian Region and segments of the Lvov and Carpathian Regions.

The Island’s own consumption in wintertime at maximum loads equals 1,000-1,050 MW. In addition to the Burshtynskaya TPP, the load is handled by Kalushskaya TPP and Tereblyarivskaya HPP. Island supplies come from generating capacities with a maximum load of 1,689 MW (nine units in operation plus one at Burshtynskaya TPP) meeting its own demand, enabling primary and secondary control per UCTE requirements and allowing for electricity exports of up to 500 MWh.

Strategically, the Island formation is a chance to integrate a part of the Ukrainian power system into the UCTE. The Island has made it possible to deliver power to Hungary, Slovakia and Romania, bring the technical standards of operating a part of the Ukrainian power system closer to European standards, and identify areas of further development of the electricity sector in Ukraine, aiming at future integration of the entire Ukrainian power system into the UCTE.

The electrical capability of Ukraine allows for not only full power supply of domestic customers, but also export deliveries of large volumes of electricity. Prospective areas of foreign economic activities in the Ukrainian power sector may include large export supplies of electricity to Belarus, the Russian UES and greater power exports to UCTE countries.

Further growth of electricity exports from Ukraine to Europe may be achieved by a gradual expansion of the Island and an ultimate switchover to synchronous operations of the Ukrainian IPS with UCTE (Ukrainian WEM integration into the UCTE). This requires comprehensive upgrading of electrical equipment and grids, as well as introduction of new IT and monitoring systems. Laying the technical groundwork for Ukrainian WEM/UCTE operations is a long-term objective of the integrationist policy and has been defined as a top priority in the Programme for Ukrainian integration into the European Union, as approved by Ukrainian President Decree No. 1072 date September 14, 2000.

In the aggregate, from November 1, 2002 to January 1, 2006 GPVD Ukrinterenergo purchased 2.3 billion kWh of electricity for the Ukrainian WEM to be exported to the Moldova power system. In addition, 2.7 billion kWh of electricity from Russia has been transited through Ukrainian grids to Moldova since April 1, 2002.

From December 1, 2004 to July 1, 2005, NAEK Energoatom exported 3.1 billion kWh of electricity to the Russian Federation.

From April 1, 2002 (when the Burshtynsky Island came on line) to January 1, 2006, GPVD Ukrinterenergo sold 13.2 billion of electricity to UCTE countries.

GP Energorynok has exported to Belarus about 3.5 million kWh of electricity since 2005 (as of January 1, 2006).

3.1.4. Strategic areas of sectoral development

The power industry is a backbone sector that satisfies national electricity requirements and is capable of generating sizable amounts of electricity for export.

The key sectoral tasks for the near term include the following:

- 1) achieve integration of the Ukrainian Interconnect Power System into the UCTE and enhance reliability of its operations;
- 2) improve energy security of the nation by decommissioning of obsolete equipment and generating capacity rehabilitation;
- 3) develop trunk backbone and interstate power grids to accommodate generator capacity (330-750 kV);
- 4) develop distribution grids (110-150kV);
- 5) reduce specific consumption of fuel associated with electricity supply//generation (especially that of fuel imports);
- 6) reduce electricity losses in transmission through power grids.

Ukraine is forecast to build up electricity output by revamping existing equipment and commissioning new capacity. In 2006-2010, NPP output will come to 91.0-101.2 billion kWh while HHP and PSP will contribute 10.3-12.5 billion kWh. TPP output is classified as the closing element of the power balance, feeding in 76.1-86.6 billion kWh.

The core of the Ukraine/European Union integration is a move of the national IPS to synchronous operation with the UCTE. In doing so, Ukraine will gain the following advantages:

- improved energy security of the nation
- high quality electricity supplies to customers; and
- increased export capability.

Synchronous operation of interconnected systems is a promising engineering solution enabling interaction of generating capacities and a full use of 330-750 kV interconnection throughputs.

With a view to achieve steady electricity exports and increase them, the plan is to:

- revamp power grids and boost generating capacity of the “Burshtynskaya TPP Island”;
- Complete Dobrotvorskaya TPP-2;
- debottleneck the power grid throughput capacity between Ukraine and Moldova by construction of additional power grids in the Odessa hub.

Strategic objectives of Ukrainian heat supply development include high quality and safe heat supplies to economic sectors and the social sphere based on the rehabilitation with the prevailing reliance on CHP in compliance with requisite environmental requirements.

During 2005, a basis was provided to attain the existing objectives:

- 1) The first phase of the Concept of Ukrainian Wholesale Electricity Market Operations and Development envisaging a gradual transition from the existing “single buyer” market pattern to a complete and competitive market in electricity;
- 2) Ukrainian Laws were adopted, envisaging:
 - dedicated mechanisms to repay debt of energy company in arrears with their payments for energy used (Ukrainian Law No. 2711 of June 23, 2005);
 - criminal sanctions for theft of electricity (Ukrainian Law No. 2598 of May 31, 2005);
 - ground rules for district heating relevant to heat generation, transmission, supply and consumption (Ukrainian Law No. 2633 of June 2, 2005).

In October 2005, the European Union supported Ukraine in its desire to accede to the Energy Cooperation Agreement to form a common gas and electricity market based on the EU rules, introduce applicable EU Directives on energy and environmental protection. A Memorandum of Understanding on energy cooperation between Ukraine and the EU was executed on December 1, 2005.

By its order, the Ministry of Fuel and Energy appointed a Coordination Board for the integration of the Ukrainian WEM into the UCTE and the advancement of electricity sector export capability. A survey of Ukrainian power systems was conducted to check them for compliance with the UCTE codes and requirements, and work areas and scopes were defined as technically required for performance within the Ukrainian regulatory and legal framework. The TACIS project in support of Ukrainian integration into trans-European networks (€3.0 million) is of great significance for Ukraine's WEM connection to the UCTE.

On May 4, 2006, an Ukrenergo request for parallel operations with the UCTE synchronous zone.

External investment has been actively solicited for the sector, inter alia, from international financial institutions to upgrade the equipment and attain the existing objectives.

The IBRD is funding an HPP Rehabilitation Project (Ukrainian Law No 3256, ratified on December 21, 2001) and preparations are being made to initiate a Power Grid Rehabilitation Project. The total price tag for IFI investment in such projects exceeds USD 300.0 million.

With a view to secure reliable and high quality power supply to customers in the South Western Region and reduce dependent on the Moldova power system, a project got underway to construct a 330 kV power supply line between Adjalyk and Usatovo. The EBRD will provide over €25.0 million in co-financing of the project (Ukrainian Law No 3576, ratified on March 16, 2006).

In addition, Ukraine has plans to construct a new 400 kV power transmission line for supplies to Romania (Artsiz-Isakca PTL). The final construction blueprint is being agreed at this point in time.

The Isakca line construction project hinges on the Ukrainian IPS integration into the UCTE

3.2. Coal sector

3.2.1. Coal sector reform and ownership

By virtue of Ukrainian President Decree No. 1417/2005 of October 5, 2005, a Ministry of Coal Industry (MCI) has been established as a legal successor to the Ukrainian Ministry of Fuel and Energy in terms of rights and obligations relating to government policy implementation in Ukraine's coal sector.

Pursuant to MCI Order No. 40, Approving the List of Government Enterprises and Business Partnerships Falling under the Jurisdiction of the MCI, dated November 24, 2005, 451 entities report to the Ministry, with 255 of them being government enterprises and 196 business partnerships, including 17 entities undergoing liquidation, 97 under reorganisation and three under formation.

As of January 1, 2006, there were 164 mines and three opencast collieries operating in the coal sector.

Organisationally, the coal sector has three management tiers:

MCI → Coal companies → Mines

Probable reserves of domestic coal stand at 117.5 billion tonnes, including explored reserves of 56.7 billion tonnes.

Ukraine's coal market capacity is estimated at USD 6.0 billion per annum. Coal output equals app. 80.0 million tonnes: 43.8 MMT of power-engineering coal and 33,9 MMT of coking coal. Government-owned mines account for over 90% of total coal output.

For lack of adequate capital investment in the coal sector, coal-extracting capacity dropped from 109.6 million tonnes to 91.5 million tonnes in 2002-2005 (almost 1.2 times down).

Key importers include Russia and Poland (11.4 MMTA), with Bulgaria, Moldova and Romania being the main export destinations (5.5 MMTA).

Coal consumption by group depends on two priority areas: coking coal making and power generation, amounting to 80% of the total.

After the Ukrainian Law on Measures to Secure Steady Operations of the Fuel and Energy Complex came into force, a positive trend towards coal sector financial revitalisation became discernable.

Collection of all types of payments for coal deliveries in 2005 amounted to 97.4% of sales and coal sector contributions to the government budget equaled 90% of the total amount assessed, representing a 8.0% increase against the corresponding period in 2004.

Government financial support is currently a precondition for normal operations of the domestic coal industry.

Given that reserve and yield addition projects are very costly, budget subsidies for capital construction are required not only to support government-owned coal companies but also increase output from all forms of ownership. Particular attention should be paid to innovative development of the coal sector, failing which it would be impossible to overcome its red-ink situation, reduce dependence on government finance or lighten the burden on the government budget.

It is evident from experience that non-government coal companies are the more efficient, including those with a difficult geological factor. According to the International Centre for Advanced Research, non-public sector accounts for 16.5% of the total number of mines in Ukraine.

Large-scale privatisation of the coal sector began in 2004. At this point in time, the non-public sector in the coal industry is represented by the State Holding Company "Pavlodarugol" (10 mines); OJSC "Krasnodonugol" (nine mines); Coal Company "Krasnoarmeyskaya-Zapadnaya Shakhta No. 1"; OJSC "Shakhta "Komsomolets Donbassa"; Zasyadko Mine, a leased enterprise being made ready for privatisation; and several small mines owned or leased by small private firms.

The positive effect of privatisation included a steep increase in coal output, greater labour efficiency and encouraged investment (in the first nine months after Pavlodarugol was privatised, coal output rose by 1.0 MMT, or 10%, and in 2005 by 2.2 MMT).

Attraction of private capital and company privatisation can bolster coal sector development.

With a view to achieve a financially balanced sector, in November 2005 the MCI came up with bill relating to coal company privatisation specifics (Draft Law on the Specifics of Privatising Coal Companies in Ukraine). The bill suggests auctioning “entire property complexes” or business subdivisions and tendering shares. It would be up to the Ministry of Coal Industry to decide in which form a business should be offered. Re-auctioning or re-tendering may result in a 50% reduction of the starting selling price.

Before proceeding to a tender or auction, the Ministry of Coal Industry must make pre-investment preparations that include transfer of the entire social package to local authorities and proposals relating to write-offs of tax arrears and bad debt.

The current version of the bill addresses the issue of budget subsidies. If the net value of an “entire property complex” is negative, the government must provide the privatised business with funds for capital construction and retooling within three years of contract of sale signing date. Promised to all government enterprises so sold are government support for liquidation amounting to at least 50% of the total value (although a precondition to a tender or auction includes accumulation of winding-up money) and interest-free business development loans for companies in need for long-term investment.

The following coal-extracting companies are slated for privatisation in 2006: Production Enterprise “Shakta Severnaya”, Government Enterprise “Snezhnoyeatratsit”, OJSC “Shakhta Novodzerzhinskaya”, Government Enterprise “Shakhta Slovyanoserbskaya”, Gayevsky Mine, Government Enterprise “Shakhta Postnikovskaya”, and OJSC “Lisichanskugol”

The Ministry of Coal Industry has stated that the following mines in the Donetsk Region are being made ready for privatisation: Krasnolimanskaya (Rodinskoye), Yuzhnodonbasskaya No.1 (Ugledar) and several mines of Government Enterprise “Makeyevugol”.

The above companies specialise in coking coal extraction.

The following major coal users have expressed interest in the purchase of such companies: SKM, Interpipe, Smartgroup, OJSC Mittal Steel – Krivoy Rog, ISD Corporation, Privat Group, and Mariupol Ilyich Integrated Iron and Steel Works

The underlying idea of coal sector reform in Ukraine is to secure fair market competition among coal companies with different rates of return irrespective of their ownership forms, using government controls (among other things, financial support).

3.2.2. Coal sector development prospects

The following tasks need to be accomplished to achieve efficient operation of the coal industry as part of the market-driven economy and improve and marketing and pricing:

- sector restructuring and commissioning of new profitable businesses;
- financial revitalization of coal sector companies and further reform of ownership relationships;
- investment support of coal company reproduction and development;
- development of a market and competitive environment in the sector;
- coal pricing and price control in conjunction with other energy pricing;
- differentiated mining rent formation, computation and collection (or refund);

- approval of economic and legal ground rules for concession development of coal deposits;
- adaptation of the domestic coal sector to the global coal market.

With a view to develop an effective legal framework for encouraging non-public investment in sectoral development and upgrading, adapting coal companies to a market environment, building up the export capability and enhancing national energy security in general, and pursuant to Supreme Rada Decree No. 2475-IV of March 16, 2005, a Ukrainian Coal Sector Development Concept (the “Concept”) has been developed. The Document envisages three phases of sectoral development and specifies key activities to attain the strategic objective of the government policy relating to Ukrainian coal sector development.

One of the mechanisms designed to secure a balance of demand and supply envisions introduction of exchange/auction trading with a subsequent transition to long-term contract trading between coal producers and users, as well as encouragement of investment through further – but this time large-scale – privatisation of coal companies irrespective of their rates of return.

In the first phase (2006-2010), the key aspect will be a comprehensive solution of the mine development issue envisaging primarily mine upgrading and further privatisation. The plan is to increase coal output to 90.9 MMTA and capacity to 105.8 MMTA by 2010. To this end, it is necessary to put into operation 17.0 MMT of new capacity through rehabilitation of operating coal companies.

In the second phase (2011-2015), the Concept offers two sectoral development scenarios. The first (base case) scenario is for achieving a coal output of 96.5 MMT by 2015, while the second (best case) scenario aims higher – 110.3 MMT with capacity requirements of 112.2 and 122.5 MMTA, respectively.

The base case scenario would ensure meeting 100% of domestic demand for power-generating coal and 89% for coking coal with domestic supply by 2015.

The second option is regarded as a best case scenario subject to certain conditions – primarily, the investment support of mine stock improvement – would make it possible to meet domestic demand for power-generating coal in full and increase such coal exports to 6.6 MMTA. This would require a faster pace of coal company development and upgrading with 20.2 MMT of new capacity to be brought on line, which could be achieved through the construction and commissioning new of mines from 2007.

The third phase (2015-2030) is treated in the Concept as a long term perspective. Given that the use of coal to generate heat would be 70% up in 2030 versus 2015, 90.5% of domestic demand for coal would be met. At the end of the reporting period, capacity should grow to 124.4 MMTA (base case) and 144.4 MMTA (best case).

The Concept is based on investment and innovative development of the coal sector and assumes a large volume of both public and private investment.

In particular, about USD 1.5 billion is to be invested in the coal sector during the first phase (2006-2010), coming largely from the government budget (58.0-63.0% of the total)

Company equity would account for about 28.0%. The balance would be covered with non-public investment, USD 0.2 billion, or 11.0-13.0%.

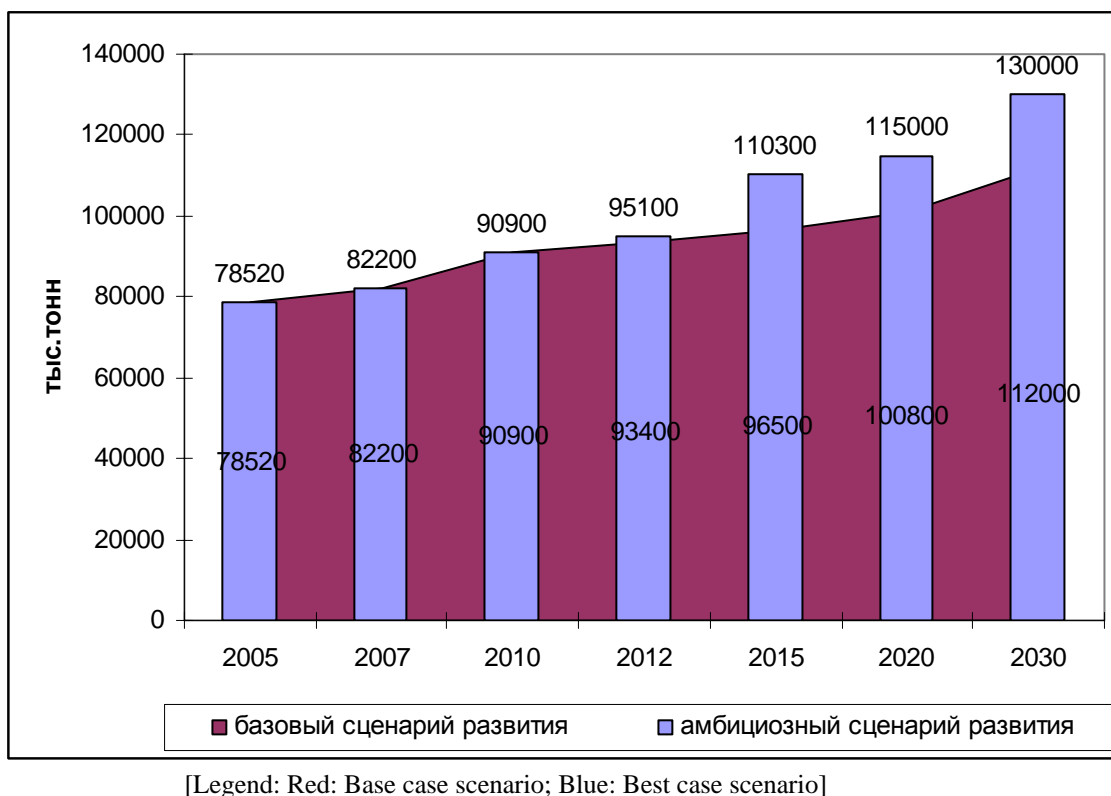


Figure 9: Forecast coal extraction balance per sectoral base case and best case scenarios

During the second phase (2011-2015), total investment requirement would be the same with a gradual reduction of the government component to USD 0.8 billion, or 50.0%, and increasing equity and non-public investment to USD 0.5 billion and USD 0.3 billion per year, respectively.

During the third phase (2016-2030), further development of the coal sector would require a gradual increase in investment to USD 1.9-2.0 billion per year. Government investment would gradually decrease to USD 0.650 billion, or no more than 39% of the total volume. Equity investment would grow to USD 0.56 billion per year, non-public investment to USD 0.3-0.55 billion per year, or 29% and 30-32% of the total, respectively.

To provide government support with incentives, the plan is for separating current company funding due to negative geological and operational reasons from effectively social aid required as a result of the past inefficient conduct of business. The former support should be rendered on a permanent basis as long as the adverse effects continue and based on factor allowances, while the latter should be temporary, i.e. it should only be provided until the company reinstates the normal operating level. In doing so, the conditions for the provision of support to a non-public mine (opencast colliery) should be spelt out in the contract of sale for the “entire property complex”.

Equalisation of coal sector rates of return in companies with differing factors due to different ownership forms through government funding and regulated use of rent receipts should contribute to the development of a competitive environment in the coal sector.

3.3. Oil and gas sector

3.3.1. Key sectoral metrics

Pursuant to Ukrainian Cabinet of Ministers Decree No. 1205, Some Matters Relating to FEC Efficiency Improvement, dated December 15, 2005, the Ukrainian Ministry of Fuel and Energy was authorised to administer the government's corporate rights in National Joint Stock Company "Naftogas Ukrainy".

The company includes three subsidiary companies (Ukrigasvydobuvannya, Ukrtransgas, Gas Ukrainy), five captive companies (Ukrnaftogaskomplekt, VZP Naftogas, Naukanaftogas, Gas-Teplo, and LIKVO), two government-owned joint stock entities (Chornomornaftogas, Ukrspetstransgas) and two open joint stock companies (Ukrnafta and Ukrtransnafta) whose controlling blocks of shares are held by Naftogas Ukrainy.

By Order No. 142 of the Ministry of Fuel and Energy, dated March 24, 2003, set up a Central Commission for Gas, Gas Condensate and Oil Field Development and Underground Gas Storage Operations to decide on a commercial development of a field or separate oil and gas reservoir based on a well-founded application from an oil and gas bearing resource user, in accordance with the Ukrainian Law of Oil and Gas, Article 36.

There are three major oil and gas bearing regions: Carathian (Western), Dneprovsko-Donetsky (Eastern) and Black Sea – Crimean (Southern). As of January 1, 2006, 336 oil and gas fields were discovered in such regions with initial reserves of 3,440.0 MMT of which 241 fields are under commercial or pilot development and the rest are being made ready for production.

Table 5: Key oil and gas exploration and production metrics in Ukraine during 2002-2005

Metrics	2002	2003	2004	2005
Prospecting and exploratory drilling, km.	219,3	232,7	218,2	246,0
Reserve additions, MMT of equivalent fuel	24,5	26,1	20,4	25,0
Gas production, BCM	18,8	19,5	20,1	20,6
Oil and condensate production, MMT	3,7	4,0	4,2	4,4

Naftogas Ukrainy entities account for about 94.0% of total natural gas production and 97/0% of total oil and condensate production. Such entities produced a total of 19.2 BCM of natural gas in 2005 of which 14.656 BCM was Ukrigasvydobuvannya production.

Explored reserves of Naftogas Ukrainy amount to 916.3 BCM of natural gas and 154.8 MMT of oil and gas condensate.

In view of inadequate funding, only one gas condensate field (Aksutinskoye) was discovered in 2005 for the account of the government budget. Four others were discovered for the account of Ukrigasvydobuvannya (Rimarovskoye (Poltava Region), Dibrovskoye (Trans-Carpathian Region), Dubanevitskoye (Lvov Region), and Vostochno-Vinogradovskoye (Dnepropetrovsk Region)).

Nonetheless, the existing Ukrainian reserves do not allow for steady incremental gas production. Gas exploration is a strategic mission of the Ukrainian gas sector.

Ukrigasbydobuvannya and Chornomornaftagas are engaged in exploration and production of hydrocarbons in Crimea and offshore in the Black Sea and Azov Sea (4.2% of Ukrainian production)

As of January 1, 2006, Chornomornaftagas develops five offshore fields (Golitsinskoye, Shtormovoye and Arkhangelskoye in the Black Sea, and Streletskoye and Severno-Kazantipskoye in the Azov Sea) and three fields onshore (Djankoyskoye and Zadornenskoye Gas Fields, and Semenovskoye Oil Field).

The Ukrainian gas transmission system (GTS) includes 37,600 km of gas pipelines and 13 underground gas storages with a total capacity of over 33.0 BCM. If fully loaded, the underground gas storages can deliver a maximum of 240.0 MCM per day.

Gas pipelines tend to run from east to west, which proves the strategic significance of the Ukrainian GTS, i.e. securing natural gas supplies to domestic customers and reliable transit of Russian and Central Asian gas to Europe. Interconnected with the unitary gas pipeline system, gas storages ensure high reliability of the entire GTS operations.

In addition to the main intended use, i.e. uninterrupted and rational supply of natural gas to customers, underground gas storages (UGS) also perform the following functions:

- additional supply of gas in the event of extreme temperature drops both on separate occasions and during abnormally cold winters, which is made possible by forming additional gas reserves in such UGS;
- creation of long-term gas stockpiles for emergencies; and
- support of reliable Russian gas transit across Ukraine to Europe.

The cold snap in January 2006 pointed to an important problem, i.e. insufficient quantities of buffer natural gas in the West Ukrainian UGS and the need to upgrade the automatic control system.

According to Ukrtransgas, the input and output throughput capacity of the GTS as of January 1, 2006, stood at 288 BCMA and 178 BCMA, respectively.

The trunkline system is currently operating with a relatively high but not maximum load factor, allowing for a potential increase of gas throughput across Ukraine with full utilisation of the transit capability. About 80.0% of Russian export gas volumes are moved through Ukraine, with each year seeing a volume increase.

According to Naftogas Ukrainy, Ukrtransgas shipped through its system 200.2 BCM of natural gas in 2005. 15.3 BCM was fed into the UGS and 17.6 BCM redelivered. Ukrainian customers received 68.9 BCM of natural gas, 0.7 BCM more than in 2004.

Gas transit to Europe and CIS countries in 2003 amounted to 136.4 BCMA, including 121.5 BCMA moved to Western and Eastern European countries – an all-time record high for the GTS.

Performed in 2005 were repairs on 175 compressor stations and smart-pigging of main pipelines, which should drastically improve transit efficiency across Ukraine. Natural gas transit via Ukraine is forecast to rise and reach 122.0 BCMA (according to the Energy Ministry)

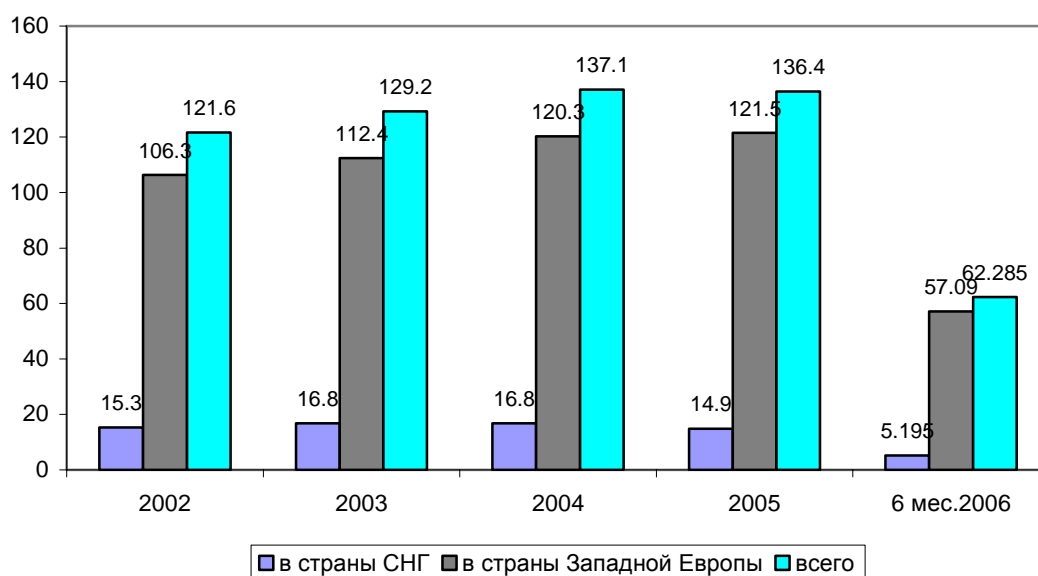
According to an update (as of July 1, 2006), a total of 62.285 BCM of natural gas was moved across Ukraine in the first six months of 2006, including:

- 57.09 BCM to Western Europe; and
- 5.195 BCM to CIS countries.

Therefore, the planned European transit obligations were exceeded by 0.752 BCM.

Payments for natural gas consumed by all customer groups in 2005 totalled 98.5%, which is 3.2% and 1.9% higher than in the corresponding period in 2004 and 2003, respectively.

Ukraine has a relatively large oil pipeline system. The country satisfies 20% of its demand for oil with domestic production, covering the shortfall with oil imports from the Russian Federation and the Republic of Kazakhstan. At the same time, Ukraine secures Russian and Kazakh oil transit to Europe.



[Legend: Blue -to CIS countries, grey - to Western Europe, green - total]

Figure 10: Gas transit through the Ukrainian gas transmission system in 2002-2005 (BCMA)

The Ukrainian crude oil pipeline system consists of two self-contained parts: Pridneprovsky Main Oil Pipelines in the East and the Druzhba Main Oil Pipelines in the West, interconnected through a Yuzhny-Brody oil pipeline completed in 2001, and includes 15 main oil pipelines with a total length of 4,570 km. The inlet and outlet oil pipeline throughput capacity in Ukraine reaches 109 and 70 MMTA, respectively.

During 2005, Ukrtransnafta's branch Druzhba moved 23,931 KT of crude oil, an increase by 17.0% (or 3,513 KT) versus 2004. (the branch Pridneprovsky Main Oil Pipelines shipped 22,767.0 KT).

In 2005, transit oil volumes accounted for 67.2% of total oil shipments with the remaining 32.8% moved to Ukrainian refineries.

In January-April 2006, oil transit across Ukraine to Western Europe stood at 10,600.0 KT.

The current financial situation of oil transport companies rules out measures to ensure their efficient operations mainly due to the heavy tax burden, oil pipeline capacity underutilisation (less than 40.0%), and degrading technical condition of pipeline facilities.

Nonetheless, there is a steady sector-wide tendency towards producer company revitalisation. For example, Ukrnafta's operational performance metrics helped to dramatically increase its financial capability. According to the 2005 results (against 2004), income from sales was 45.3% up, reaching 8,342.5 million hryvnias (USD 1,652 million), while net income from sales was 27.8% up, amounting to 5,575.2 million hryvnias (USD 1,104.0 million), with all government budget contributions rising by 1,635.2 million hryvnias (USD 323.8 million).

3.3.2. Sectoral investment processes

Prospective investment projects

The need for investment in the Ukrainian oil and gas sector is dictated by the fact that the sector in which the majority of fixed assets require drastic upgrading continues to be now a major contributor to the national coffers.

Investment is needed to attain the following objectives:

- prospecting for, exploration and continued commercial development of hydrocarbon fields;
- expansion of existing gas and oil transportation systems;
- capacity rehabilitation and expansion of gas, crude and product storages;
- oil, gas and gas condensate processing capacity rehabilitation and new construction;
- expansion of oil and gas sector marketing chains; and
- participation in international oil and natural gas exploration and production projects.

Hydrocarbon exploration and production investment priorities include, *inter alia*, the following:

1. intensified development of oil and gas reserves in the Black Sea and the Azov Sea;
2. achieving steady oil and gas production and its subsequent enlargement through intensified recovery from existing fields and new fields brought on line;
3. resource base build-up and participation in the development of other country resources (Central Asia and Middle East countries); and
4. participation in natural gas production and transportation infrastructure development projects in CIS countries, as well as in pipeline projects.

The higher prices for Russian and Central Asian gas have provided an impetus to diversification and intensified production of domestic resources. Given that any dramatic increase in onshore gas production is unlikely (the north-eastern fields in Ukraine are 70.0-80.0% depleted with new discoveries being only capable of keeping production at the present level), the development of, and commercial production from, offshore Black Sea and Azov fields are of strategic significance to Ukraine.

By an expert estimate, the eastern portion of the Black Sea holds up to 3.5 trillion tonnes of equivalent fuel, which comparable with the largest fields in the Caspian. About 1.5 trillion t.o.e. is within Ukraine's territorial waters.

The only Ukrainian company that is working on the Black Sea bed is Chornomornaftagas. Drilling depths do not exceed 70.0 m. In 2005, the region produced 1.2 BCM of natural gas (generally, production does not go beyond 3.0% of explored reserves). By a geological estimate, only one third of reserves in Black Sea fields occur at small depths. Large investment is required to develop prospective fields.

The first step in that direction has already been made. In December 2005, the Ukrainian Government called a tender for exploration and production of energy carries from the Kerch segment of the Black Sea. Such companies as Shell (UK), ExxonMobile (US), Chevron (US), Hunt Oil (US) (jointly with Ukraine's Chornomornaftagas), and Petrobras (Brasil) said they would take part. The estimated price tag of the project is about USD 2.5 billion.

The most successful bidder would claim half of the production under Ukraine Law No. 1039-XIV on Production Sharing Agreements (PSA), dated September 14, 1999. The subject-matter of a Kerch offshore segment PSA would cover three fields Odesskoye (Olympiyskoye), Besymyannoeye and Pallasa. According to Chornomornaftagas, given that Ukraine does not have any know-how to develop fields occurring at depths between 200 m and 2 km, a PSA would be the only appropriate option.

Based on the outcome of the tender, on April 19, 2006, the Ukrainian Cabinet of Ministers declares Vanco International Ltd (Switzerland), a subsidiary of Vanco Energy Company (US) to be the most successful bidder for the development of the Kerch segment in the Black Sea. According to the company management, drilling a well in the Black Sea will cost USD 60-100 million., Vanco will invest in the field development at least UDS 100 million in the first three years to be followed by at least USD 150 million more in the next three years. The company plans a more sizable investment for a third two-year period. After each period, the company will relinquish 25% of the total area back to government ownership. In the event of a positive outcome with at least one well, Vanco is prepared to invest in it USD 2.9 billion (with bank guarantee amounting to USD 110 million).

By an analyst estimate, another tender may be held in September 2006 for the Skif petroliferous area in the western part of the Black Sea, with OMV Group of Austria having already displayed interest in it.

In general, the plan is for annual offshore production of 4.0 BCM of natural gas.

At their meeting with the Ukrainian Minister of Fuel and Energy on November 8, 2005, Transeuroenergy (US) said they were prepared to invest in offshore exploration and production in the Black and Azov Seas.

On December 1, 2005, Naftogas Ukrainy and Shell (UK) signed a cooperation agreement for a commercial development study of a 31,000.0 m² area in the Dneprovsko-Donetsky Region, which might hold significant natural gas reserves.

Ukrigasbydobuvannya and Shell executed a large-scale joint operations agreement for oil and gas exploration in the Hague on June 8, 2006.

Under the terms of the joint operations agreement, Shell will work on eight blocks in the Dneprovsko-Donetsky Basin licensed to Ukrgasvydobuvannya with access to potential deep reservoirs (5-7 km deep). For this purpose, Shell will invest upfront about USD 100 million. Shell will have a 50% share in the joint operations agreement to apply to such licenses (except for the field currently under development) in exchange for obligations to collect seismics and drill exploration wells within three years. The work is expected to start in June 2006.

In addition, a memorandum of understanding has been signed between Naftogas Ukrainy and Shell Exploration on access to the Ukrainian gas transmission system and assured gas transit across Ukraine to the border.

A key issue of great relevance to the foreign investor at this point in time is natural gas pricing for Ukrainian customers. The question whether it will supply its gas entitlement (under the PSA) to the domestic market or export destinations continues to be governed by agreements with the government. If foreign companies are not happy with the gas prices applied to Ukrainian customers, they will want to take the gas out of the country, which is impossible without access to the government gas transmission system. At its time, the Russian Federation where the "Gasprom single export channel" rule exists also encountered a similar problem. The gradual leveling of gas export prices (taking into account transportation costs) and domestic prices helped to resolve the problem.

When using a PSA, note should be taken of the fact in some cases the investor may not be interested in field development: offshore hydrocarbon production projects are costly and do not always pay off in difficult fields. In this case, incentives should be put in place to produce all kinds of reserves including those with difficult recovery by applying tax and other concessions, e.g. differentiated rent for production. There should also be an entry to securities markets.

One way to attract investment in the sector is to use the Kyoto Protocol mechanisms of Joint Implementation (JI). Potential JI projects might include gas transmission flow optimisation and use of energy-saving technologies (equipment replacement and rehabilitation at compressor stations; introduction of cogeneration and turboexpander units; diagnostics of equipment and main pipelines)

Property issues

In 2005, Naftogas Ukrainy drew down two tranches of a Deutsche Bank AG credit line and a long-term loan from Standard Bank London (for a total of USD 200 million). The aggregate debt capital received by Naftogas Ukrainy in 2005 came to USD 600 million and was unsecured (the Ukrainian company did not lodge any security).

Such money was the first lending to a Ukrainian resident on such terms, which is proof of foreign investor confidence in Naftogas Ukrainy

Having assessed the factors that favourably affect the credit standing of the company, investment bank analysts from WestLB AG and Merrill Lynch confirmed that Naftogas Eurobonds were highly attractive.

Given that pursuant to the existing laws of Ukraine gas companies, main pipeline facilities and underground gas storages are government property and not subject to privatisation and with a view to ensure sectoral competitive conditions, foreign investment may be drawn through joint ventures (JV) to be set up in sector infrastructure.

The Ukrainian-UK JV Poltava Gas and Oil Company (JV PGOC) is one of successful joint ventures formed to implement a long-term investment project in the Ukrainian oil and gas sector. JV PGOC is a small non-public oil and gas producer.

Under the terms of a Licensing Agreement signed between the Ukrainian State Geology and Subsoil Resource Committee and JV PGOC as licensee, the company has been granted the exclusive right to hydrocarbon prospecting, exploration and production in the Novo-Nikolayev field cluster and holds license to operate Novo-Nikolayevskoye, Ignatyevskoye, Molchanovskoye and Rudenkovskoye Fields. The company is also exploring two more prospective areas – Zaplavskaya and Krasnopolskaya.

Based on the outcome of the first auction to sell licenses for prospective areas and mineral deposits, which was held by the Environmental Protection Ministry of Ukraine, JV PGOC was granted a special permit (license) to exploration of the eastern part of Krasnoyarskoye Field (pilot commercial development inclusive). According to the State Geological Service, gas reserves in this block are estimated at 1.2 MMT of fuel equivalent.

In the course of its operations, the company has drilled six exploratory wells and three production wells and repaired 11 wells. Total production came to 1 MMT of oil and almost 2.4 BCM of natural gas.

On September 30, 2005, Cardinal Resources (UK), an independent oil and gas producer with fixed assets in Ukraine, purchased 100% of the charter capital of the Kiev-based producer company “Drilling Company “Rudis”. Cardinal Resources plans a drastic increase in its operations in Ukraine in the near future as a result of oil and gas asset acquisition. Since 2001 Rudis has held license for exploration (including pilot commercial development) of Belousovsko-Chernukhinskaya area and since November 2002 similar licenses for Severo-Yablunovskaya and Dubrovskaya areas. In addition, the company has a 50% interest in a joint operations agreement with Ukrgasvydobuvannya for oil and gas well renewals.

Considering the positive experience gained by other investor companies, at the end of 2005 Polish Polskie Gornictwo Naftowe i Gazownictwo S.A. (PGNiG) expressed willingness to make sizable investments and arrange for oil and gas production project implementation in Ukraine. PGNiG also offers assistance to Ukrainian companies in obtaining cheaper financing for oil and gas projects because lending costs in Ukraine are considerably higher than in Poland.

In addition, the Polish party expressed interest in leasing gas storages in Ukraine. PGNiG is now considering proposals from Lvovtransgas, a main gas pipeline department, about an underground gas storage lease near the Polish border. PGNiG is currently involved in hydrocarbon production from Sakhalin Oil and Gas Condensate Field (Kharkov Region, Krasnokutsky District) through Devon, a Kiev-based Russian-Ukrainian JV, in which the Polish company holds 36.38% of shares (Interfax of Ukraine).

In late October 2005, at the fifth Ukraine-EU economic forum in Lvov, Naftorgas Ukrainy and US investor companies Bortex Enterprises and ComOxy LLC signed a memorandum for the construction of an oil refinery and a set of related facilities in Brodovsky District in Lvov Region (“Brody Integrated Complex”). The project includes two phases: construction of an 8 MMTA (Phase 1) and the construction of a thermal power plant and farm produce processing facilities (Phase 2). In the aggregate, the project will cost USD 3 billion. According to Bau Consult GmbH, a dedicated international organisation that audited the project, the estimated payback of Phase 1 would be five years.

The new refinery cut yield will be 95.5% and this project will help to load the Odessa-Brody pipeline with Caspian and Middle East crudes.

The Ukrainian Government will shortly consider and approve exempting equipment imports from VAT against an avalised note for successful implementation of this investment project. Private investor funds need to be attracted to rehabilitate Ukrainian refineries to conform to specifications and parameters used in Western Europe.

In late 2005, a deal was struck involving the sale of oil assets – 97% of shares in Odessa Refinery to LUK-Sintez Oil Limited (according to IFG Sokrat). The plan is for investing about USD 500 million to upgrade this business. In 2006, 32% of Galichina Refinery shares also changed hands.

The main objective of refinery privatisations is to find the investor that has the money first of all, while the prisatisation process as such should involve “entire property complexes”.

GTS projects and international cooperation

The Ukrainian oil and gas transportation system now has adequate R&D support. During 1999-2005, the cost-benefit ratio of investment in R&D work by Ukrtransgas rose from 0.51 in 1999 to 2.05 in 2004 and the R&D payback period equaled 0.71 year. These are good enough metrics to draw investment in the sector.

As far as the existing oil and gas transportation capacity expansion is concerned, of particular interest are the Bogorodchany-Uzhgorod gas pipeline construction project with throughput increases to 5 BCMA in the first phase (from 2006) and 19 BCMA in the second phase (in 2010) and the creation of a Euro-Asian Oil Transportation Corridor (EAOTC) interconnecting Baku, Supsa, Odessa, Brody and Europe for the transportation of Caspian and Middle East crudes across Ukraine to the European markets.

The Bogorodchany-Uzhgorod gas pipeline will be constructed as part of second gas line construction between Ukraine’s eastern and western borders towards Novopskov-Uzhgorod (as an extension of the Alexandrov Gai – Russia – Novopskov gas pipeline) allowing for an increase of natural gas transit through Ukraine by 20-30 BCMA in 2013.

In the Agreement on Measures to Secure Strategic Cooperation in the Gas Sector executed by the Russian and Ukrainian heads of government in Sochi, Russia, in 2004, the Russian party provided guarantees that the above volumes would be shipped through this pipeline and the Ukrainian party provided tax concessions for the construction and payback periods.

The first phase of the EAOTC project is already complete: the Odessa-Brody oil pipeline within Ukraine and an oil transshipment complex in the Port of Yuzhny have been constructed.

The first phase throughput of the oil and gas corridor equals 9-14 MMTA. Following full build-out, the throughput capacity will come to 45 MMTA of oil 30 MMTA of which will be shipped for transit through the Odessa-Brody oil pipeline and then on via a prospective Brody-Plotsk (Poland) oil pipeline.

The competitiveness of the Odessa-Brody system is based on a lower total transportation tariff.

A TACIS programme for advisory support on technical, economic, financial and legal matters in developing a conceptual design of a Odessa-Brody-Plotsk oil transportation system (€2 million) got underway in December 2005. Working groups have been formed: one for Ukraine-EU technical support in the field of hydrocarbons and the other for Odessa-Brody-Plotsk project support, whose activities are maintained under separate technical aid projects of the INIGATE Programme and the EC with coordination from the Ministry of Fuel and Energy.

At their meeting in Warsaw on February 16, 2005, the heads of government of Ukraine and Poland discussed finalisation of the Odessa-Brody-Plotsk pipeline and organisational forms of cooperation between the parties in project implementation. The parties agreed to start drafting a comprehensive agreement between the two countries to systematise intergovernmental cooperation in implementing the Odessa-Brody-Plotsk project.

The EAOTC project may be implemented through Ukraine's participation in international cooperation such as a consortium to be based on the international pipeline company Sarmatia set up in accordance with the 2003 Ukrainian-Polish intergovernmental agreement on Odessa-Brody capacity utilisation.

With a view to boost oil exports to international markets, the governments of six countries (Ukraine, Russia, Belarus, Croatia, Slovakia and Hungary) executed a Druzhba/Adria oil pipeline integration agreement. This project would allow for an increase in shipments through the oil pipelines of such countries to 5-10 MMTA.

The Ukrainian Energy Strategy for the Period until 2030 provides for the production of 3.6 MMTA of oil outside of Ukraine until 2010 with a production build-up to 9.2 MMTA by 2030. Gas production by Ukrainian companies abroad during the same period is to reach 2.3 BCMA with an increase to 11.6 BCMA.

To this end, Ukraine has been an active participant in oil and gas projects abroad. According to the State Foreign Investment Service of the Turkmenistan President, in 2005 Ukrainian companies participated in 14 projects implemented in Turkmenistan for a total of USD 1 billion (construction of a gas lift compressor station in the Goturdepe Oil Field, a line compressor station on the Turmen-Uzbek border (Deryalik), etc.). In 2005, Turkmenistan supplied 4.5 BCM of natural gas of the contracted 36 BCM per the main agreement.

The investment plan of Naftogas Ukrainy for 2006 amounts to 500 million hryvnias (about USD 100 million), The priorities include the United Arab Emirates, Egypt, Libya, Kalmykia and the CIS.

Summary

Despite the aggravated risks associated with the election campaign, the pace of incremental capital investments in Q1 2006 reached 15.9% (a 4.5 times increase against the corresponding period in 2005). Foreign direct investment amounted to USD 922 million, or 3.9 times greater than last year, which is an all-time record high during Ukrainian independence.

In the first six months of 2006, bank lending increase by one fourth. In Q2 its growth rate was 2.5 times higher than the Q1 number. As of June 1, 2006, long-term lending rose to 63% (against 56% in 2005) and investment credits to almost 18% (versus 11% in 2005).

For the purpose of achieving legislative changes towards the creation of reliable investor right protection mechanisms, the Ukrainian President and Cabinet of Ministers passed a number of legislative acts aimed at a positive turnaround in terms of foreign business attitude to the Ukrainian economy (Ukraine President Decrees No. 625 of April 11, 2005, No. 1116 of July 19, 2005, No. 1513 of October 28, 2005, and No. 300 of April 10, 2006, as well as UCM Decree No. 666 of August 2, 2005)

To simplify the permitting process for business entities, the Supreme Rada of Ukraine passed Ukrainian Law No. 2806-IV of September 6, 2005 on the Business Permitting System, which envisages measures to improve the government/business relationship framework and harmonise Ukrainian business laws with applicable European legislation.

In 2005-2006, financial revitalisation of the fuel and energy sectors continued.

(For information: In January-December 2005, electricity bill payment equaled 99.1%, a 3.1% increase versus 2004. Actual collection in the first six months of 2006 was 96.3% and 96.6% for electricity, 3,537.2 million hryvnias more than in the corresponding period last year.)

Ukrainian Laws have been adopted, envisaging:

- dedicated mechanisms to repay debt of energy company in arrears with their payments for energy used (Ukrainian Law No. 2711 of June 23, 2005);
(For information: Mutual settlements to repay debt and write off energy company debt for a total of over USD 270 million; and between January 1, 2005 and July 1, 2006, energy supply company debt to the wholesaler amounting to app. USD 297.0 million was also repaid.);
- criminal sanctions for theft of electricity (Ukrainian Law No. 2598 of May 31, 2005);
- ground rules for district heating relevant to heat generation, transmission, supply and consumption (Ukrainian Law No. 2633 of June 2, 2005).

With a view to resolve issues in the coal sector and make it profitable, as well as enable its operation in a market environment and attract investment:

- a Coal Industry Ministry has been established;
- a decision has been approved to reduce by 30% the railway rate for coke, coking and power generating coal exports;
- coal sector payroll arrears incurred as of April 1, 2005, have been decreased

(except for coal-extracting companies) by USD 4.3 million secured by assets.

A Ukrainian Law on Amending the Customs Rate has been adopted (No. 2470 of March 15, 2005), reducing oil product excise rates and compulsory charges on crude and product imports destined for Ukraine. Simultaneously, the additional customs duty on motor fuels has been cancelled and a foreign trade quota system introduced for domestic oil and motor fuel exports. On the one hand, this helped to establish government control of domestic crude and product exports and, on the other hand, open up the internal market for petrol and diesel fuel imports.

2005-2006 saw intensified efforts to attract IFI investment in energy projects. The IBRD electricity sector investment portfolio amounted to over USD 300 million and that of the EBRD to more than €67 million.

A full-scale cooperation agreement was signed with Shell on June 8, 2006 to achieve diversification of domestic hydrocarbon production. The cooperation will be based on a production sharing agreement (PSA) in Dneprovsko-Donetsk Basin (upfront investment of about USD 100 million).

A tender has been held for commercial development of the eastern part of the Black Sea and hydrocarbon production from the Kerch offshore area, with Vanco International Ltd (Switzerland) named as the most successful bidder. The company will develop the offshore Kerch area based on a PSA with the minimum investment of over USD 250 million.

During 2005, foreign investment was actively drawn through the formation of joint ventures in the oil and gas infrastructure to enable a competitive environment in the sector.

A positive trend has become discernable in the liberalisation of land relationships: the Ukrainian Land Code and a number regulatory documents have been amended to simplify the purchase of government and public land plots by foreign individuals and legal entities.

Commencing at the end of 2005, privatisation processes have resumed in the energy sector. Six coal companies and the government share blocks in three regional electricity companies are slated for privatisation in 2006.

To improve the privatisation legal framework, a number of bills have been submitted for approval to the central executive authorities and Supreme Rada committees, seeking to enhance public sector efficiency by optimising the public asset structure and develop a differentiated government property privatisation mechanism for each property category (e.g. a Ukrainian Draft Law Amending Certain Privatisation Laws).

It should be specially emphasised that the European Union attaches great importance to mutual cooperation with Ukraine in the energy sphere and the facilitation of a gradual integration of its energy sector with the EU energy market.

Considering the material progress made in July-October 2006 by the working group in implementing the Memorandum of Understanding between the European Union and Ukraine on Energy Cooperation (the "Memorandum"), the Fuel and Energy Ministry, for one party, and the European Commission, for the other party, signed aide-memoirs on September 14 and October 24, 2006.

The documents reflect the significance of the European Union's investing – through the relevant European financial institutions such as the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) – in infrastructure projects in

the Ukrainian energy and oil/gas sectors to enhance the transparency of, and improve, the existing transit infrastructure, as well as support integration processes.

In this connection, the European Commission indicated its willingness to earmark to Ukraine up to €500 mln worth of financing in the first half of 2007. In addition, the desire is stated to continue identifying future infrastructure projects in the energy sector that could use the benefit of EIB and EBRD support after a new mandate of the EIB is approved for 2007-2013.

Such agreements emphasise the EU's confidence in the political and economic reform in Ukraine, confirm a better investment climate in the country and improve its economic image worldwide.