

Electricity market opening – still work to do

Ukraine's electricity wholesale market has been opened for competition on 1st of July. In theory, large retail suppliers and industrial consumers can now buy electricity freely from different generators on the open market. Hopes are that this will lead to a more efficient electricity sector. However, despite two years of preparation, there are concerns that the sector is not yet ready for the opening.

In particular, there are concerns about a lack of competition due to the low number of producers. Furthermore, technical questions such as how to organise metering and settlement of payments have not been answered satisfactorily. A complex system to compensate the difference between market-based wholesale prices and regulated tariffs for households which are below market prices blurs price signals.

These issues need to be addressed before any further opening steps are undertaken to ensure a proper working of the market and for benefits to materialise. The risk is implicitly acknowledged by Ukrainian regulators, that introduced a tight corset of temporary price-caps for all market segments. Failure to resolve these issues endangers the stability of the electricity system, resulting in potentially high economic cost.

Why to open the market?

Since 1st of July Ukraine's electricity wholesale market is open for competition. The so-called market opening means that electricity producers may now directly sell their electricity to retailers and large companies and the wholesale electricity price will be determined by demand and supply. Prior to the market opening, electricity was bought centrally at prices set by the state-owned regulator. Providing wholesale electricity through a market has, at least in theory, a number of advantages. If the market functions well, it may actually reduce wholesale prices and thus the cost of electricity. Equally important, market-based prices provide incentives for electricity producers to invest in new plants and to close down old, inefficient ones. Market-based pricing is also efficient in telling operators when to produce electricity and when not (optimal dispatch). While these are benefits worth pursuing, energy markets experts have repeatedly voiced doubts as to whether all the prerequisites for a working market are in place yet.

Lack of competition

One of the concerns relates to the low number of companies producing electricity, which could lead to an abuse of market power. In a wholesale electricity market, the electricity price is typically set by demand and

supply. This can be done through a bidding process or bilateral contracts. If there are enough producers and thus competition, the price is determined by the marginal cost of the most expensive power plant needed to meet demand. In Ukraine, coal-fired thermal power plants (TPPs) can be expected to have the highest production cost and will thus be determining the price in most cases. However, ownership of TPPs is concentrated among one major producer, DTEK. As there is a lack of alternative generators, this operator may use his market power to withhold capacity or increase bids in order to increase his revenues.

There are further concerns about the degree of competition among retail suppliers, i.e. those companies that buy electricity from the producers in order to provide it to private households and small companies. In order for competition among retail suppliers to work, access to the distribution grid needs to be equal for all retail suppliers. This is typically achieved by separating distribution system operators (DSOs) from the retail suppliers – so-called unbundling. It is of concern that this unbundling has not yet progressed sufficiently in Ukraine. One and the same company may be providing electricity to households and operate the distribution grid and thus could favour its own retail arm by obstructing competitive retail suppliers who want to use their grid. A lack of competition and higher prices would be the result.

Technical readiness

In addition, there are worries that not yet all technical instruments and processes needed for a well-working market are in place. Measuring electricity consumption (metering) and the quick exchange of consumption data are essential technical prerequisites for a working electricity market. Quite similar to private households wishing to switch suppliers, without metering and data exchange, there will be confusion regarding how much electricity has been consumed. This might eventually result in errors or delays in billing and consequently in refusals to pay bills. In the wholesale market, where electricity is traded even at hourly intervals, real-time metering and data exchange is even more important. While in Ukraine, metering electricity generation is generally in place, the system has not been designed for competitive supply.

Furthermore, there does not yet seem to be a clear mechanism in place to deal with private households and small businesses who continue to receive their electricity at a fixed regulated tariff below the market price (the public service obligation). Since prices are fixed, these households do not have any intention to change suppliers, so there will not be any competition.

It thus needs to be clarified how this segment of the market is distributed among potential retail suppliers.

Day ahead market prices on 3rd of July



Source: 3rd of July, Energorynok

First experiences and next steps

Despite these concerns, the market opening took place on 1st July – albeit in a so-called “safe mode”. This mode foresees price-caps in order to avoid price spikes. The first days of trading showed market prices were indeed very close to the price-caps. This suggests that there is, as of now, hardly any competitive bidding and the market price is dictated by the price-caps.

Experience from European countries which opened their electricity markets in the last 20 years shows that similar measures to protect consumers from sudden price hikes have been used. Because the supply side of Ukraine’s market is quite oligopolistic, measures to mitigate market power abuse (expressed in excessive prices) are in principle justified. However, these measures are imposing strong limits on competition.

While prices at most market segments are non-regulated, a lot of electricity is sold through a specific complex system from state-owned generators to certain eligible consumers at regulated prices.

Given the described unresolved issues and ongoing political changes, we expect an eventful development of the Ukrainian electricity market in the coming weeks and months. For this reason, we will provide a regular monitoring report of the electricity market opening in Ukraine on our project website.

Conclusions

There is good reason to believe that the market opening was premature. Further opening steps should wait and the safe mode extended until the most pressing technical issues have been resolved. Meanwhile close monitoring is needed to detect and resolve any issues that threaten system stability or signal market abuse. Once the open technical issues have been resolved, steps need to be taken to increase competition in the market. This could be achieved by privatising remaining

state-owned coal-power plants, increasing cross-border capacity and enabling real imports and exports through Burshtyn Island – a thermal plant in western Ukraine which has some of its units synchronised with the ENTSO-E system. These measures could serve as important trial runs towards Ukraine’s long-term goal of full synchronisation with the ENTSO-E system. Assuming that the risk of the premature market opening can be contained and competition increased, Ukraine might develop an electricity market that indeed leads to a more efficient use and development of the power system.

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