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NEWSLETTER

UKRAINE

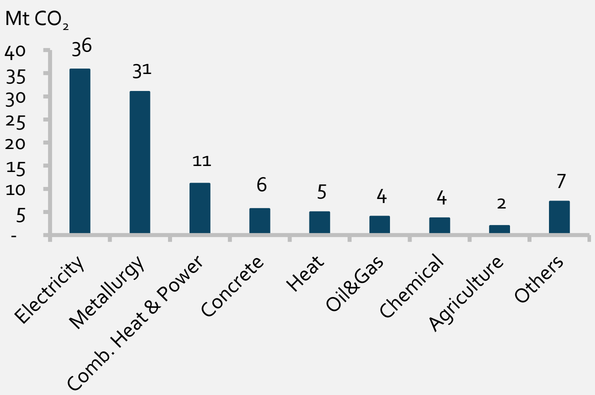
Reforming CO_2 taxation: Current proposals and outlook

The current Ukrainian CO_2 tax is too low to have any effect on reducing emissions. Discussions on increasing the CO_2 tax are ongoing among policymakers. However, the focus in these discussions so far is less on reaching effective levels for driving decarbonisation, but more on revenue generation and its fiscal use. On the backdrop of international discussions and commitments, several government institutions are preparing proposals for introducing a national climate fund which could channel CO_2 tax revenues into a green modernisation of industry. Another proposal currently discussed concerns financing renewable electricity feed-in tariffs through CO_2 tax revenues instead of a consumer levy. Overall, the course and ambition of Ukrainian climate policy remains unclear, creating uncertainty for investors, businesses, and policymakers alike.

Status quo

Ukraine already has a carbon tax in place. It covers larger stationary sources of emissions (over 500 tons p.a.). Being the largest stationary emitters, electricity generation and metallurgy make up about two thirds of the current tax base. However, the current tax rate is one of the lowest among countries that impose a tax on carbon. With currently UAH 10 (~EUR 0.30) per ton of CO_2, it is too low to stimulate companies to implement energy saving or fuel switching technologies. Additionally, lack of proper accounting, interaction of public authorities and control over pollution allowed many eligible taxpayers to avoid paying the full tax in past years.

Taxable CO_2 emissions per sector, 2020



Source: data.gov.ua

In January this year, a monitoring, reporting and verification (MRV) system for greenhouse gas (GHG) emissions has been introduced. However, it still remains to be fully implemented.

Recent legislative reform proposals

There are several legislative proposals to increase the tax rate on CO_2 emissions and/or expand the tax base to include other sectors of the economy not currently covered such as transport and residential heating. One proposal currently registered as a draft law in parliament includes a provision to increase the tax rate to UAH 30 (~ EUR 1) per ton of CO2.

More ambitious reform proposals with the 2nd NDC

There are also proposals to increase the existing tax rate to UAH 150 (~EUR 5) or more. Resulting tax revenues could be channelled to a proposed national climate fund supporting a green modernisation of Ukraine's industry. Discussions on a national climate fund have started with the development of the draft 2nd Nationally Determined Contribution (NDC). It aims at reducing economy-wide GHG emissions by at least 65% below the 1990 level. While Ukraine has already experienced emissions reductions by 61.2% from 1990 to 2018 due to structural changes after the dissolution of the Soviet Union, the draft 2nd NDC is nonetheless relatively ambitious taking into account that emissions are expected to grow by about 15% until 2030 without adopting additional policies. In the electricity system alone, investments of approx. EUR 27 bn until 2030 are needed to achieve the desired emission reductions and simultaneously create a well-functioning electricity system, according to our estimates. Additional investments are needed in other sectors, especially for modernising Ukraine's industry where adequate incentives for decarbonisation are currently missing. An increased CO_2 tax, together with a national climate fund, could provide such incentives while concurrently helping overcome restrictions in the financial capability of companies to finance required investments and remain profitable despite the additional requirements and costs.

Reform proposals and CBAM

This debate has gained momentum with the substantiation of the EU Commission's plan for a carbon border adjustment mechanism (CBAM), designed to prevent carbon leakage due to increasing EU carbon prices. Instead of burdening Ukrainian exporters of carbon-intensive products – first and foremost steelmakers – with heavy CBAM charges, Ukraine could levy their own carbon price gradually reaching levels comparable to the EU in the medium- to long-term. Through a national climate fund, revenues could then partially be used to support steel companies and other industrial companies in their modernisation and decarbonisation efforts. In fact, several government institutions are preparing several proposals for a national climate fund. The Ministry of Environmental

Protection and Natural Resources has recently declared they are developing a proposal for a Ukrainian climate fund aimed at supporting the modernisation of industry. According to the declaration, it would be set up as a separate legal entity and financed by the CO_2 tax and other environmental levies. Meanwhile, the Ministry of Energy and the Office of the Deputy Prime Minister for European and Euro-Atlantic Integration are developing their own proposals for a national climate fund. While more ambitious domestic CO_2 taxation could potentially preemt the risk of CBAM, opponents of a higher CO_2 tax are still hoping to strike down the EU proposal at the WTO or to receive an exemption and would rather see the Ukrainian carbon tax remain at current low levels.

Higher CO_2 tax to finance renewable feed-in tariffs?

Instead of financing a national climate fund, there are also discussions within the government whether a higher CO_2 tax could be used to pay for obligations to producers of renewable electricity. Renewable electricity supply (RES) is incentivised through feed-in tariffs (FIT) in Ukraine. Until 2019, new RES plants were entitled to a fixed tariff for feeding in renewable electricity to the grid from the state-owned Guaranteed Buyer. While the Guaranteed Buyer resells this electricity on the day-ahead and bilaterals market, the resulting revenues are substantially below payment obligations for the FIT. Currently, FITs are partially funded through a levy on final consumers, although this levy remains insufficient to cover the gap in payment obligations (creating payment arrears to RES producers of currently ~EUR 1 bn). The above proposal would entail to finance FITs with revenues from an increased CO_2 tax instead of the consumer levy. Our analysis shows that current (2020) FIT payments could be financed through a tax of UAH 400 (EUR 12-13) per ton of CO_2. In addition, such a CO_2 tax increase would result in higher day-ahead market prices for electricity, resulting in windfall profits for state-owned enterprises that (re)sell low-carbon electricity (Energoatom, Ukrhydroenergo, Guaranteed Buyer) and additional VAT and excise tax revenues. Price increases for final commercial consumers would remain limited as the current levy on final consumers to finance FITs could be lifted. Residential consumer prices are currently regulated at levels below cost coverage, i.e. implicitly subsidised, and would remain unaffected.

Outlook

Ukraine is currently at a crossroads between enacting relatively ambitious climate policies or continuing a carbon-intensive development path. While the government has announced the target of carbon neutrality by 2060 and signalled support for the European Green Deal aiming for net zero emissions by 2050, the draft 2nd NDC has not yet been adopted and concrete measures to achieve the announced targets are still lacking. This includes the lack of a predictable path for increasing the CO_2 tax to effective levels. While deliberation within the government and parliament regarding Ukrainian climate ambitions are ongoing, so are discussions for increasing the CO_2 tax and potentially expanding the tax to other sectors.

Conclusion

It remains to be seen what proposal will prevail and how CO_2 taxation will be embedded in a broader set of energy and climate policies. Meanwhile, the current situation creates uncertainty for investors, businesses, and policy-makers alike. Climate policy will not and never has been a purely domestic affair, however. With the European Green Deal reshaping virtually every aspect of EU internal policy-making, EU neighbourhood, trade and foreign policy begin to evolve, too. While CBAM discussions already shake up relations with the EU's trade partners, including Ukraine, it might soon be complemented with a nascent European climate diplomacy. Constructive discussion and cooperation on decarbonisation measures is in the mutual interest of the EU and its neighbours. Thus, carbon taxation and climate finance could very well be an increasingly prominent cornerstone of European Neighbourhood Policy and bilateral relations with Ukraine.

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