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UKRAINE LEGAL AND POLICY SUPPORT
Investigation of Impact of Taxation Law on Settlement
between Market Members (Task A4)
Investigation of Legal Issues of Market Members Restructuring
Their Debts and Settling Accounts Payable and Receivable with
State-Controlled Enterprises (Task A5)

NIS Institutional Based Services Under the
Energy Efficiency and Market Reform Project
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Ukraine Power Sector Reform
Delivery Order No 18

Final Report

Prepared for

U S Agency for International Development
Bureau for Europe and NIS
Office of Environment, Energy and Urban Development
Energy and Infrastructure Division

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EXECUTIVE SUMMARY

The current Report was prepared with the objective to fulfill the following tasks of Delivery Order # 18 Legal and Policy Support Project Statement of Work "Impact of Taxation Law on Settlement Between Market Members" (A 4) and "Legal Issues of Market members Restructuring Their Debts and Settling Accounts Payable and Receivable with State Controlled Enterprises" (A 5)

The Report includes as Appendix A a legal review and analysis drafted by the legal company "Aktive" regarding issues, which have special importance for future operation of the Wholesale Electricity Market (WEM) of Ukraine, relationships between WEM Members and competence of the National Electricity Regulation Commission (NERC) of Ukraine. The separate part of the Report deals with development of provisions of the draft Law of Ukraine "On Principles of Functioning of Wholesale Electricity Market of Ukraine"

The Report includes also certain conclusions related to the compliance of the Draft Wholesale Electricity Market Members' Agreement (WEMMA) proposed by the WEM Board to the acting Ukrainian legislation, and the legal analysis of the Draft Temporary Regulation on Separate Division "Energoynok" (energy market)

Appendix B to this Report contains an overview of issues related to legal provisions of the Draft WEMMA investigated jointly with the NERC legal department, which had received appropriate recommendations regarding specific provisions of the Draft WEMMA. The WEM Board Session of September 2nd, 1998 offered to the Energoynok representatives jointly with Hagler Bailly consultants to analyze the Draft Agreement between Energoynok (specifically - "Ukrenergo" State Enterprise) and Suppliers that operated based on a regulated tariff. That became necessary due to the fact that the general WEMMA did not regulate the legal procedures and responsibilities of Suppliers for electricity nor the procedure of defending the Generators' interests in courts. The appropriate document is attached to this Report as Appendix C.

APPENDIX A

DRAFTED BY THE
LEGAL COMPANY "AKTIV"
SUB-CONTRACT NO D-168-005-P-8-932
AS OF AUGUST 1, 1998

LEGAL OPINION ON INVESTIGATIONS AND ANALYSES CONDUCTED IN COMPLIANCE WITH TASKS 3-5 AND RECOMMENDATIONS ON BRINGING REGULATORY AND LEGAL ACTS OF NERC IN COMPLIANCE WITH WEMMA

This Legal Opinion has been prepared by the law firm "*Active*" in accordance with Subcontract Agreement No D-168-005-P-8-932 of August 1, 1998 under the supervision of *Hagler Bailly, Inc* within the project in support of the power sector restructuring and legal reform in Ukraine. The Subcontract Agreement sets a task to prepare a legal opinion on investigations and analyses specified in tasks 3 - 5, as follows:

To study the impact of the tax legislation of Ukraine on settlements between the participants of the electricity market, taking into account the operations that are being carried out and those which are being proposed in the new Draft WEM Agreement,

To investigate legal issues on restructuring by Market Members of their debts and settling accounts payable and receivable with budget enterprises in compliance with the Financial Recovery Plan,

To render assistance to NERC in developing recommendations to the working group established to draft the Law of Ukraine "On the Wholesale Electricity Market".
While preparing this legal opinion we have considered the following legislative and regulatory acts:

The Constitution of Ukraine, the Civil Code of Ukraine, the Arbitration Procedure Code of Ukraine, legislative acts of Ukraine "On Ownership", "On Enterprises in Ukraine", "On Entrepreneurship", "On Businesses", "On Limitation of Monopoly and Prevention of Unfair Competition in the Entrepreneurial Activity", "On Electricity Sector", "On Auditing

Activity", ' On Value-Added Tax' "On Taxation of Enterprises' Income' as well as relevant Decrees of the President of Ukraine Resolutions of the Cabinet of Ministers of Ukraine and internal regulatory acts of the Ministry of Energy the National Electricity Regulatory Commission of Ukraine and the National Bank of Ukraine in that part which relates to the regulation of the electricity sector

Several meetings have been held with leading specialists from the National Electricity Regulatory Commission (NERC)

This Legal Opinion consists of the following sections

STRUCTURE OF THE WEM MEMBERS' AGREEMENT,
VALUE-ADDED TAX,
INCOME TAX,
PAYMENT FOR ELECTRICITY,
JUDICIAL BODIES AND THE PROCEDURE OF SETTLING DISPUTES BETWEEN THE WEM MEMBERS,
GENERAL ANALYSIS OF THE COMPLIANCE OF THE DRAFT WEM MEMBERS' AGREEMENT PROPOSED BY THE WEM BOARD ON SEPTEMBER 2, 1998 (DRAFT 3) WITH THE CURRENT LEGISLATION OF UKRAINE
THE DRAFT INTERIM PROVISIONS ON SPECIALIZED SEPARATED UNIT "ENERGOMARKET"
CONCLUSIONS

1 STRUCTURE OF THE WEM MEMBERS' AGREEMENT

In the previous legal opinion prepared under the subcontract agreement we analyzed the compliance of the Members' Agreement of the wholesale electricity market of Ukraine (hereinafter referred to as the WEMMA and the WEM) with the current legislation of Ukraine, and elaborated proposals, which, we think, will make the WEMMA easy to read and understand, and will facilitate its application

In this section of the legal opinion we propose only the scheme of the WEMMA which may be the following

Chapter I Preamble

- Section 1 Parties to the Agreement
- Section 2 Terms and Definitions
- Section 3 General Provisions

Chapter II WEM Membership

- Section 1 Rules for Admission of New Members in the WEM
- Section 2 Rules for Termination of Membership in the WEM
- Section 3 Withdrawal from the WEM Membership

Chapter III Managerial Bodies of the WEM

- Section 1 General Meeting of the WEM Members
- Section 2 WEM Board
- Section 3 Secretariat
- Chapter IV WEM Infrastructure (Election Procedure Rights and Duties)
 - Section 1 System Settlement Administrator
 - Section 2 Market Funds Administrator
 - Section 3 Central Dispatch
 - Section 4 Metering
 - Section 5 Legal Service
- Chapter V Market Auditor
- Chapter VI Market Banker
- Chapter VII Rights and Duties of WEM Members
 - Section 1 Rights and Duties of Generators
 - Section 2 Rights and Duties of Commission Agent
 - Section 3 Rights and Duties of Suppliers
- Chapter VIII Liability of the WEM Members
- Chapter IX Dispute Settlement Procedure
- Chapter X Procedure of Making Changes and Amendments to the WEM Members Agreement
- Chapter XI Duration of the Agreement
- Chapter XII Other Provisions

Revision of the text of an agreement is very difficult and labor-consuming work which is not provided by the subcontract agreement. However, we can perform this work under a separate agreement.

2 VALUE-ADDED TAX

The current legislation of Ukraine stipulates that the date of origin of VAT payment obligations shall be the date falling on a tax period*, during which any of the previous events took place, or

- the date of transfer to a taxpayer's bank account or
- the date of shipment of goods

The Presidential Decree of August 7, 1998 stipulates that until January 1, 2000 the date of origin of tax obligations for electricity sales shall be the date of transfers to a taxpayer's bank account in payment for goods to be sold, and the date of origin of the right to take up a tax credit from the seller of these goods shall be the date of drawing funds in payment for goods purchased by the taxpayer. This clause of the Decree does not apply to alienation or purchasing of goods through barter businesses.

Under the law a tax period is a quarter, in the end of which a taxpayer has to file a quarterly tax return

For a buyer of electricity a date of origin of right to a tax credit shall be the date of drawing funds from the taxpayer's bank account

The analysis of the legislation of Ukraine on payment of VAT enables us to make a conclusion that under the current legislation a pattern of relations based on commission agreements is more efficient. The fact is that the value-added tax is to be paid in every case of transferring property in the goods.

In the power sector electricity is such goods. In accordance with the existing pattern of relationships in the WEM under the sale contracts, the property in electricity is transferred twice on its way from generators to suppliers. First, from a generator to NDC and then from NDC to a supplier. Thus, the value-added tax is likely to be paid twice on the same goods. At the first stage, a person liable to pay a tax is the Generator and at the second stage the NDC. Should the state of payments be normalized and the tax rate be established other than 0% payment of the VAT will increase from the moment of funds remittance on the taxpayer's account.

Since the tax obligation arises from the moment of shipping the goods or rendering services or receiving payments for these goods or services, it is necessary to make a clear legal interpretation of the notion of "shipment of electricity."

When goods are received for sale under the commission agreement the proprietary right is not to be transferred. In other words, given the use of the commission agreement an object taxable for the total value of the goods will appear only once, not twice. This will promote optimization of tax payments.

Furthermore, under the multiple transfer of the proprietary right sales volume gets increased for all parties to such relations, and, therefore, other payments will increase, e.g., roads tax payment to the innovation fund, etc.

The issue on avoidance of such a cascade effect has been raised during talks on the loan agreement between Ukraine and the World Bank. Thus, if these proposals would be included in the agreement, Ukraine can be able to abide by its obligations under this agreement. As a matter of fact, the application of the existing tax legislation evidences that legal consequences for generators and NDC after the payment of the value added tax do not depend upon the agreement, commission or sale, if the parties to these agreements timely file tax statements. Different tax consequences under these agreements will be with regard to an income tax, a road tax and payments to the innovative fund. Here, there is an advantage of the commission agreement for the NDC.

3 INCOME TAX

Pursuant to the Law of Ukraine "On Company Income Tax" (hereinafter referred to as the Law) the taxpayers are subjects of the entrepreneurial activity which are engaged into business aimed at drawing a profit. Having analyzed the draft WEMMA and taking into account the above-mentioned, we can arrive at a conclusion that all Parties to the WEMMA are the payers of the income tax.

This analysis has been made based on the legal relationships within the commission agreements proposed by the draft WEMMA. Principles of the current scheme of settlements within a framework of sale agreements are explained in the course of analysis. The objects of taxation shall be the income determined by reducing the sum of the adjusted gross income by the sum of the taxpayer's gross costs and allocations for depreciation in keeping with the procedure established by the Law.

Let's consider the principles of imposition of a tax on income drawn from basic activities of each Party, that is, from electricity sale/purchase.

Generators The major activity of this class of Participants is the production of electricity to be further sold through the WEM to the other participants. Gross income from the major activity for them will be income realized from the general volume of electricity sales to the WEM at a stipulated sale price.

Let us assume that all payments for the sold electricity shall be done through clearing system by the way of clearing accounts, clearing offsets and barter. In other words, cash payments shall be excluded.

In this case, the date of increasing gross income, and, therefore, of arising tax obligations shall be the date falling on a tax period during which any of the previous events took place, or the date on which the buyer's funds were transferred to the taxpayer's bank account or the date of shipment of goods.

In order to avoid an inexpedient recognition of income (income actually not received) it is necessary to apply a legal procedure to settle bad debts. The Law recognizes that, given such conditions, reduction of accrued income is considered sufficient for tax accounting. When funds are received, the date of originating the tax obligations shall be determined according to bank statements on the funds flow through the bank account. The date of shipment of electricity shall be determined by metering data.

In the case of barter, the date of increasing gross income shall be the date of any of the events that happened previously, or the date of shipment of electricity, or the date of receipt of

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goods in the case of works, the date on which the taxpayer actually received their results that is acceptance certificate

Peculiarity of electricity sales under sale agreements consists in the fact that when using the legal procedure to settle tax problems, the burden of these problems will primarily be put on the NDC, which threatens its existence as a subject of management

Suppliers The major activity of this class of participants is the purchase of electricity in the WEM and its sale to the final customers. Generators can also act as Suppliers. When selling electricity through the WEM under commission agreements, the right of ownership in electricity shall be transferred from Generators to Suppliers. Gross income for Suppliers is the total amount of revenues received from electricity sales to customers at a sale price i.e. at regulated and non-regulated tariffs. The date of increasing gross income shall be determined in the same way as that for Generators.

Regular tax rules apply to taxation of the suppliers' activity, if carried out under sale agreements

Dispatch Operator Its major activity is dispatch management of the united power grid of Ukraine

In accordance with the draft WEMMA the NDC acts as a dispatch operator. Gross income of the NDC is a commission included in the price of electricity sold through the WEM. Pursuant to the draft WEMMA the NDC is a Commission Agent. Therefore, the ownership right of the Generator shall not be transferred to it, and gross income for this WEM Member will be the sum of commissions (revenues) received or due for the services the NDC renders. The sum of commissions (revenues) shall be included in the sales price of electricity sold to suppliers. The date of increasing gross income of the Dispatch Operator shall be either the date of remittance of funds on the bank account or the date of receipt of electricity by the supplier. With the purpose to defer the date of origin of the Commission Agent's tax obligations we propose to stipulate in the commission agreement that the actual availability of the results of services rendered by the Commission Agent shall be not only the delivery of electricity but also the transfer of funds to the bank account for electricity supplied. In this case the date of origin of the Commission Agent's tax obligations shall be the date of remittance of funds on the bank account. This will help to avoid taxation of unreal (not yet received) income. If the electricity is sold under the sale agreements, the right of ownership in electricity is transferred twice, i.e. from the Generators to the NDC and from the NDC to the Suppliers which also has an effect on the taxation. In this case the NDC as a party to the sales agreement, shall become an owner of electricity and, therefore, shall have the tax obligations even if it has not received payment from the Suppliers for the electricity delivered.

Settlement System Administrator, Market Funds Administrator and Metering System Administrator These parties to the WEMMA ensure the WEM operation. Their gross

income shall be based on surcharges included in the price of electricity sold through the WEM. Having taken this into account the fact that their services are permanent the date of increasing gross income for these participants shall be determined in the same way as that for the Dispatch Operator. A proposal on the taxation optimization for the Dispatch Operator is not suitable here. Therefore, we propose to stipulate in the WEMMA what shall be considered as the actual rendition of services by these Parties to the Agreement having brought the date of the rendition of services nearer to the date of receiving payments.

The procedure of determining gross and depreciation is specified in the Law. This procedure is the same for all participants, and, in our opinion, does not require detailed analysis.

4 PAYMENT FOR ELECTRICITY

Analysis of settlements effected in the WEM and with customers enables us to make a conclusion that in the sphere of the power sector, along with non-cash settlements there are following kinds of settlements:

Settlements through Offsets

The mechanism of using offsets to make payments for electricity directly between the generators and suppliers is determined in the Procedure for conducting non-bank settlements for electricity supplied to the customers. This Procedure has been developed by the Ministry of Energy and approved by the National Electricity Regulatory Commission, the State Committee on the Nuclear Energy and the Ministry of Economy of Ukraine.

Participants in offsets are the generating companies (creditors of the NDC), electricity suppliers (debtors of the NDC) and customers - debtors on the payment for the consumed electricity. The volume of offsets for customers shall amount to the sum of a debt of the customer and in no way release the latter from payment for the current electricity consumption.

The Ministry of Energy shall set volumes of offsets for creditors of the NDC and suppliers. At present offsets are being conducted based on the protocols approved by all participants of such settlement.

We believe that it would be efficient to use this method of settlements in the further practice.

Settlements with the Use of Transfer Orders

These settlements shall be done based on the method approved by Directive of the Ministry of Energy No. 2 of March 29, 1998 "Procedure of Settlements with Entities of Entrepreneurial Activity Engaged in Fuel Supply to Generators and Nuclear Power Plants and Removal of Nuclear Fuel Waste."

The fuel suppliers have been given the right to receive electricity only from the WEM to the account of supplies of fuel (equipment) or services on removal of nuclear fuel waste on the condition that they are WEM Members and have licenses to supply electricity and separate contracts with generators, suppliers and customers.

Generators under such contracts shall draw up a reconciliation report writing on debts and submit to the NDC a transfer order as an agreement to write off mutual debts for electricity supplied to and received from the WEM

Debts to Suppliers of the fuel shall be settled by supplying them with electricity from the WEM. From the moment of origin of the debt for such electricity supply the Market Funds Administrator shall write it off and send a notification of this to a fuel supplier and electricity generator

Settlements by Assignment of a Claim

A legal basis for such settlements is Presidential Decree No 285 of April 2 1997 and Resolution of the Cabinet of Ministers No 487 of May, 21,1997

Pursuant to the legislation of Ukraine the assignment of a claim was made by concluding a relevant agreement between a creditor and a third party without a debtor's consent. An initial creditor notified a debtor of the assignment of a claim. An agreement on the assignment of a claim was concluded with the consent of all parties. From that moment a new creditor fulfilled obligations under the agreement.

The assignment of a claim was effected between oblenergo, NDC, generating company and its creditor. The assignment of a claim of companies – electricity consumers was implemented. In this case, the NDC wrote off its debts to the generator (account payable) and debts of the oblenergo (account receivable). At the same time the generator paid off its debts to its creditor.

However, the Presidential Decree of March 4, 1998 prohibits the assignment of a claim.

Remittance of Debts with the Use of Bills of Exchange and Promissory Notes

The WEM Members make the remittance of debts by using bills of exchange and promissory notes.

The first method The generators shall adjust with all participants to a transaction settlements under concluded agreements, using promissory notes issued either by customers or suppliers of fuel and give a guarantee to the supplier and the NDC for the acceptance of these promissory notes from the NDC in account of repayment of debts for electricity supplied to the WEM.

Thereafter each party shall draw up a certificate of acceptance of the promissory note and place an endorsement. This acceptance certificate shall be the basis for writing off mutual debts.

Second method A supplier of fuel (equipment) shall make settlements with its creditor by using a bill of exchange, a payer on which is a generating company (generator). Then to carry out offsets, the generator shall present to a bank another bill of exchange, the payer on which is the NDC.

Upon obtaining the consent of the customer and supplier the bank shall make offsets to the account of payment of bills of exchange and send a notification of writing off debts to the generator, supplier and NDC.

This method of settlements has a number of negative factors

First the holder of a bill does not have a guarantee that this bill will be accepted in payment for a debt for electricity. This leads to another drawback, i.e. the NDC acts as a primary debtor on all non-payments which may result in its bankruptcy and put its existence as a subject of management under threat.

Taking into account a tight situation with payments for electricity consumed, existence of the old outstanding debts, we consider it necessary to restructure accounts receivable and payable with the aim of establishing reasonable and agreed terms for repayment of debts.

Based on the analysis of feasibility to repay existing debts, we may propose to repay debts by using bills of exchange and promissory notes and other debts-settling instruments offered by commercial banks under the certain discounts.

Also, it is necessary to determine amounts of bad debt, which shall be written off at the expense of creditors with the use of mechanism of creating the reserve fund.

5 JUDICIAL BODIES AND THE PROCEDURE OF SETTLING DISPUTES BETWEEN THE WEM MEMBERS

In the previous opinion we offered a procedure settling disputes which may arise between the Members of the WEMMA, having worked out the Instruction on Procedure for complaints and claims settlement.

At the same time, dynamics of the relations between the WEM Members, the necessity to swiftly remove conflict between them and specifics of the subject matter of the activity (electricity) requires the creation of the Arbitration Court within the WEM system. Therefore we would like to offer another scheme to settle disputes between the WEM Members which, in our opinion, will allow facilitating the procedure, reducing time of dispute settlement and decreasing costs of proceedings.

The Arbitration Court is a contractual form of settling disputes between the WEM Members, the participants and other persons under the jurisdiction established by the Provisions (Code) on Arbitration Court of the WEM.

The WEM Board shall approve the Provisions on Arbitration Court. Provisions shall include the interpretation of terms used, determination of parties to the procedure, their rights, jurisdiction and the rules of court during hearings, procedure to initiate arbitration, requirements for the claims, replies to claims and counterclaims, time-limit for proceedings, requirements to qualifications of the arbitrators and order of their selection, ruling of the court and execution of its decisions.

We also propose to establish within the WEM the institution of mediation, that is the institution of an out-of-court dispute settlement between the WEM Members. Briefly, any party or parties to the dispute or claim shall have the right to initiate the procedure of

mediation by signing a contract on transferring the case for the mediation and to choose a mediator

A procedure for mediation may be set forth in detail in the "Rules of Mediation" With the object of adhering by the WEM Members to the requirements established by legislative and internal regulatory acts as well as influencing the persons who violate these requirements disciplinary actions may be taken against them These actions may be taken by the Arbitration and Disciplinary Committee to be created in the WEM which shall operate on the basis of Provisions elaborated to this effect The Committee may be responsible for consideration of disciplinary cases according to the Disciplinary Code of the WEM Members The Disciplinary Code shall stipulate the procedure and grounds for disciplinary impact on violators

6 GENERAL ANALYSIS OF THE COMPLIANCE OF THE DRAFT WEM MEMBERS' AGREEMENT PROPOSED BY THE WEM BOARD ON SEPTEMBER 2, 1998 (DRAFT 3) WITH THE CURRENT LEGISLATION OF UKRAINE

The general analysis of draft 3 allows us to make a conclusion that some of its provisions may not be accepted for they are inconsistent with the current legislation This concerns the transfer of duties of the Settlement System Administrator and the Market Funds Administrator to the Commission Agent (under draft 3 it is a specialized subdivision of the National Electricity Company "Ukrenergo", which acts on behalf of the latter with the authority of by-laws) The NEC "Ukrenergo" shall perform the duties of the Metering System Administrator and specialized separated unit "Energomarket" shall act as the WEM Board Secretariat

Based on the principle of voluntary contractual relations the parties shall determine to their discretion, who will be responsible for the above-mentioned duties, as well as set up an election procedure for them

The WEM Board shall be understood as a body to which any dispute can be submitted for settlement, and which is put on the same level as the Arbitration Court This is essentially wrong At the same time Article 7 stipulates that in the case of failure to reach an agreement between the parties they shall be entitled to apply to the Arbitration Court

Besides, draft 3 has a lot of inaccurate statements inconsistent provisions and drawbacks on which we pointed out in Section 7 "On the Draft Agreement of the Wholesale Electricity Market of Ukraine, proposed by firm 'Factorial'" of the Legal Opinion on the compliance of the draft Agreement with the current legislation of Ukraine

This section sets out only some general provisions. The more detailed analysis of draft 3 may be the subject matter of a new subcontract agreement.

7 THE DRAFT INTERIM PROVISIONS ON SPECIALIZED SEPARATED UNIT "ENERGOMARKET"

Decrees of the President of Ukraine "On Measures on the Market Reforms in the Sphere of the Power Sector of Ukraine" No 244/94 of May 21, 1994, "On Restructuring of the Electric Energy Complex of Ukraine" No 282/95 of April 4, 1995, "On Measures on the National Policy in the Sphere of Natural Monopolies" No 853/97 of September 19, 1998 and Resolution of the Cabinet of Ministers of Ukraine "On Approval of the Financial Recovery Plan" No 508 of April 18, 1998 envisage the reorganization of the National Dispatch Center of Ukraine. This reorganization envisages the creation of enterprise "Energomarket" to act as the Market Funds Administrator.

In compliance with Section 1 of the Law of Ukraine "On Entrepreneurship in Ukraine" an enterprise (a company) shall be an independent legal entity with its own authorized capital engaged in industrial, scientific and research and commercial activity with the purpose of receiving profit. Such enterprise shall not incorporate any other legal entities.

As the statement indicates, the regulatory acts of the government have established that the form of a newly created legal entity shall be solely an enterprise, not an affiliate or a specialized separated unit.

According to Minutes No 31 of the meeting of the Cabinet of Ministers of Ukraine of August 19, 1998 (Item 5) Minenergo and NERC shall be obliged to speed up the transfer of the duties of the Market Funds Administrator and Settlement System Administrator from the NDC to the enterprise "Energomarket". In this case, the question is not about the National Electricity Company "Ukrenergo", which has already been set up, but about enterprise "Energomarket", which has not been yet created.

Pursuant to Article 7 of the Law of Ukraine "On Enterprises in Ukraine" enterprises can set up affiliates, separated subdivisions. Such separated subdivisions shall act within the powers given to them by a legal entity.

In compliance with Regulation No 3 approved by Resolution of the Board of the National Bank of Ukraine, No 36, of February 4, 1998, (hereinafter referred to as the Regulation No 3), the rights of the separated subdivisions as to the use of foreign currency funds transferred to its bank current account shall be restricted as follows:

Receipts from marketing goods and services after transfer to the current account of the separated subdivision shall be transferred to the current account of the legal entity in full.

Funds of a separated subdivision (within the limits given by the leading enterprise or purchased on the currency market) may be used to carry out the following operations according to approved estimate

To pay expenses for the business trips and to secure operational needs of the vehicles when outside of Ukraine,

To pay salaries to non-resident employees, who work under the contract in this subdivision and their remuneration requires payment in hard currency

To purchase for the own needs of the branch equipment furniture and so on if a contract is entered into with a non-resident

The branch acts on behalf of the company and within the latter Statute and its own by-laws. Therefore when the branch enters into a contract, the company acquires contractual rights and obligations only when it empowered the branch for that.

We also would like to draw your attention to the fact that as of today NDC and a state energy company "Ukrelectroperedacha" have been consolidated, and a new state-owned company the National energy company "Ukrenergo" has been incorporated. In other words NDC of Ukraine does not exist anymore, and the duties of the administrator of funds were transferred to NEC "Ukrenergo".

Based on the above-mentioned, we believe that in order to incorporate a new company "Energorynok" it is necessary to amend several governmental acts (decrees) considering a already incorporated NEC "Ukrenergo," or recognize the incorporation of the NEC "Ukrenergo" as illegal (unlawful registration) or liquidate it.

Currently the reorganization of NDC into a state-owned company "Energorynok" is questionable for NDC does not exist.

Having analyzed the Provisional Statute on Specialized Separate Subdivision "Energorynok" we would like to draw your attention to the following:

The creation of a separate subdivision is a provisional measure, only as a first step on the way to the company (Sec 1.1).

Also the decrees of the President and the Cabinet of Ministers did not stipulate the form of an entity for "Energorynok" for it has been left to the body empowered to do this. At the same time these decrees did mandate to incorporate a company but not subdivision. As a result the creation of the separate subdivision is inconsistent with the mentioned decrees.

Duties of a subdivision
administrator of settlement,
administrator of funds,

accounting,
secretariat,
contractual activity,
claims and legal actions etc ,(Sec 2 2)

However, under the decrees of the President and the Cabinet of Ministers NEC "Energorynok" only has duties of the administrator of funds and the administrator of settlements of the WEM

In a case of the reorganization of NDC, not a merger, its duties have to be transferred to a company Also the other duties under the WEM agreement have to be transferred to a newly incorporated company, which are not only attributable to it and thus may not be provided in the regulation for they are contractual by nature Source of the property of a company (Sec 4 2) profit gained as a result of the commercial activity, profit from the sale of the securities

Such funds in the foreign currency after arrival at the bank account of the subdivision must be transferred to the bank account of the company and the possibility of its return is for a subdivision's use rather distant, especially if the company itself has debts property gratuitously contributed from other legal entities, acquisition of the property of the other companies and organizations, Since the company and its subdivision is a property of the government, all property which such a company or subdivision acquire also become the property of the government No such company can enjoy or use or dispose at its own discretion such a property without a prior approval by the Fund of the State Property or a specially authorized body

loans of banks and other creditors, Sec 2 1 3 and sec 6 1 4 of the Regulation of the National Bank of Ukraine do not allow a separate subdivision to open a credit account Only a company is granted such a right to have a credit account with a following allocation of these funds to the subdivision

Property of the subdivision can be disposed only in accordance with a ruling of a court or an arbitration court (Sec 4 5)

This provision limits allowances for disposal of the property stipulated by the law for example, by the decision of the owner (government), by the execution notice of the notary public or by the order of the investigative bodies etc
The subdivision has the right to purchase real estate within the allocated funds approved by NERC

As an executive body NERC has the right to allocate funds to a company, and the latter can do the same with regards to its subdivision and approval of such allocation can be done only when a budget or special funds allotment provide for such approval

The current legislation (Sec 31 of the Civil Code of Ukraine) provides that the subdivision in all transactions within the power given to it by a company and on behalf of that company and a head of the subdivision acts based on the power of attorney not on the agency contract (Sec 6 3)

Funding the subdivision shall be made directly from a bank account of the NEC "Ukrenergo " an allotment account of the WEM (Sec 7 1 1) centralized funds of the Ministry of Power Industry and other sources (Sec 7 1 2)

Funding of the activity of the subdivision from the allotment account of the WEM funds of the Ministry of Power Industry etc can be done only through the bank account of a company and not directly to the bank account of the subdivision

The subdivision shall create special funds necessary for its activity (Sec 7 3)

Only a company is empowered to create special funds and only for its own use including its subdivisions and branches Therefore the creation of these funds by subdivisions is unlawful

8 CONCLUSIONS

In the first section of the memoranda we offered a scheme of the WEM Agreement Finishing off the text of the agreement can be done under another contract

A value-added tax has to be paid only once not twice provided that the contract of agency has been used for a sale of electricity This will optimize the tax payment At the same time under the multiple ownership right transfer, a sale turnover of all parties increases and therefore other payment will increase e g , a roads tax, payment to the innovative fund etc

If the these amendments are to be included into the WEM Agreement in the proposed edition, Ukraine will have to abide by its obligation under the loan agreement between it and the World Bank

In order to avoid accountability for tax purposes of the income (income actually not received) it is necessary to apply a legal procedure to settle hopeless indebtedness The law recognizes this procedure, under which an adjusted income is enough for tax accountability

Taking into account the difficult situation with payments for the consumed electricity and existence of the old outstanding debts, it is necessary to conduct the restructuring of debts and settling of accounts receivable and payable and to agree on a reasonable timeframe for a repayment of the debts

Based on the reality as to the repayment of the debts the settlements of all debts can be done using bills of exchange and promissory notes and other debts-settlement instruments offered by the commercial banks under the certain discounts

Also it is necessary to determine the amount of the hopeless account receivable which have to be written off for the account of creditors using the mechanism of a reserve fund

Since the tax obligation arises from the moment of shipment of goods or rendition of services, or receiving payments for these goods or services, it is necessary make a clear legal interpretation of the notion "shipment of electricity "

With a purpose of the tax obligation deferment of the agent, it is necessary to stipulate in the contract of agency that a date for the services rendered by the agent for the tax purposes is not only a date of shipment of electricity but also a date the agent receives payment for the electricity delivered. In this case a date for the tax obligation will be the date when the money has been transferred to a bank account. This will help to avoid taxation of not yet received income

To resolve disputes, which may arise among the WEM Members we offer to introduce to the WEM the institutes of the Commercial Tribunal and mediation. Corresponding documents may be drafted under a separate agreement

We also can prepare a detailed analysis of the compliance of the draft the Wholesale Electricity Market Members Agreement, offered by the Council of the WEM of 02 09 1998 (draft #3) to the current legislation

The draft of the Provisional Statute on the Specialized Separate Subdivision "Energorynok" can be approved provided "Energorynok" is a legal entity not a subdivision. All duties that are granted to the subdivision are attributable to the company only

All mentioned issues have to be reflected in the legislative act of Ukraine "On the Wholesale Electricity Market of Ukraine "

APPENDIX B

MEMORANDUM

TO O Samborska, Chief of NERC Legal Department
SUBJECT Draft WEM Member's Agreement

We have considered your draft WEM Members' Agreement. Proposed comments result from the previous brief analysis of this draft Agreement. The draft WEM Members' Agreement proposed by NEC "Ukrenergo" stipulates the following:

1. The Generators and the Commission Agent (NEC "Ukrenergo") shall conclude, along with joint WEM Members' Agreement, also bilateral commission agreements. This means that legal relations which arise between Generators and the Commission Agent have double legal status.

The WEM Members' Agreement is, as a matter of fact, a complex multilateral agreement, but relations, which arise between Generators and the Commission Agent, are built on a bilateral agreement with the participation of many parties. This means that each Generator shall transfer to the Commission Agent the right to dispose of its (generator) electricity and entrust the Commission Agent with concluding agreements on sale of this electricity on its behalf, and the Commission Agent shall be delegated to conclude such agreements and return to generators all it received under agreements concluded.

Another commission agreement to be concluded by each Generator with the Commission Agent separately is also a bilateral agreement. Moreover, this agreement shall be made on the same subject, the same terms and conditions, and by the same entities as the WEM Members' Agreement. In legal aspect, this means that these agreements fully coincide. But physically, these will be two agreements with the same subject, terms and conditions, entities, etc., which shall not be both valid. Accordingly, one of the agreements shall be considered invalid, i.e. concluded without the aim to create legal consequences for its parties (Part 1, Clause 58 of the Civil Code of Ukraine). Pursuant to Clause 15 of the Law of Ukraine "On Electricity Sector", the wholesale purchase and sale of electricity in Ukraine shall be effected through the wholesale market, which, in its turn, shall be created on the basis of the Agreement. The agreement shall stipulate the purpose and conditions of the activity rights.

commitments and responsibilities of its parties. That is, the WEM Members' Agreement cannot be considered invalid, since laws specify its existence. Thus, one can come to a conclusion that after concluding bilateral separate sale agreements there will be grounds to consider them invalid from the moment of their conclusion.

2. The Suppliers and the Commission Agent, which has already acted as the Seller, shall, along with the WEM Members' Agreement, conclude bilateral sale agreements. These bilateral agreements give rise to the same situation as bilateral commission agreements. And in addition to this, one can say about creation of several monopolies and monopsonies, that is, markets in which only one seller and one buyer act. This situation is prohibited by Clause 15 of the Law of Ukraine "On Electricity Sector". If, let's assume, any Party to the Agreement applies to an arbitration court for violation of its rights, the court shall consider the grounds of origin of legal relations and determine whether the rights are actually violated. Pursuant to the effective legislation, one of the grounds of origin of legal relations is an agreement. But there will be two agreements that regulate the stated legal relations and rights will be violated under the two identical agreements. In this connection, the court shall determine which of the agreements is valid and which is invalid. It may be foreseen that the court will give preference to the agreement that is considered by the law binding.

3. Item 11.1 of Section "Transitional Provisions" of the proposed draft agreement binds Suppliers to re-conclude agreements with customers having envisaged therein the fulfillment of obligations in favor of the Commission Agent in compliance with Clause 160 of the Civil Code of Ukraine, provided that the Supplier and the Commission Agent carry out joint commitments. These provisions contradict the current legislation in several aspects.

In the first place, the WEM Members' Agreement regulates the relations between Generators, Suppliers, and the Commission Agent. So it shall not specify any obligations for the third parties (customers). Provisions on re-conclusion of agreements between Suppliers and customers can be valid only when customers will wish to terminate the old agreement voluntarily and to conclude a new one or make changes and amendments to the old one. Furthermore, the principle of retrospective action of a law is valid in the civil law. This means that changes and amendments made in agreements shall be effective from the date of signing these changes and amendments by parties. If any customer rejects to re-conclude the agreement with the Supplier, nobody has the right to force this customer to do it. So, this rule of the draft Agreement is not binding for the parties to the Agreement and in no way applies to the customer.

In the second place, Provisions on the conclusion of the agreement in favor of the third party (the Commission Agent) in compliance with Clause 160 of the Civil Code of Ukraine runs counter to the established procedure of settlements. Actually, the Civil Code contains the law, which grants the right to conclude agreements in favor of the third party. However, this agreement for

legal entities shall have to be considered invalid as such since it does not meet the law for the following reasons

Item 5 of Decree of the President of Ukraine No 227/95 of March 16 1995 'On Measures to Normalize the Payment Discipline in the National Economy' stipulates that sales proceeds and outstanding amounts shall be entered to the same account. This shall be understood that if Suppliers sell electricity to customers then only Suppliers and nobody else shall have the right to receive payments from customers for electricity sold. Joint Resolution of the Cabinet of Ministers of Ukraine and the National Bank of Ukraine No 811 of June 5 1998 'On Establishment of Special Procedure of Settlements for Electricity Sold to Customers' has approved an appropriate Procedure. Item 2 of this Regulation stipulates that payments by customers for electricity purchased shall be made solely in the clearing account of the Supplier to be then transferred to the Commission Agent account. It is obvious from the above statements that a condition of making an agreement in favor of the third party contradicts the current legislation.

In the third place, Provisions on solidarity of the Commission Agent and the Supplier in the right to claim for performance of payment liabilities from customers also contradict the current legislation. Joint claims of creditors may arise out of the law or the agreement. As to the sale agreement with the customers, it could not be concluded (see Item 3 of this memorandum) on the stated conditions. Such an agreement if concluded, shall specify grounds for joint claims of creditors (that is, the Commission Agent and the Supplier) to the customer. One of the grounds shall be the transfer of electricity to ownership of the customer under the agreement by which the sellers shall be the Commission Agent and the Supplier. But this contradicts the Law of Ukraine "On Electricity Sector" which stipulates that customers shall purchase electricity solely from Suppliers, and electricity from the wholesale market, i.e. from the Commission Agent shall be sold solely to entities which hold appropriate licenses for electricity supply.

It is obvious from the above statements that, under conditions specified in Item 11.1 of the draft, the WEM Members' agreement cannot be concluded.

4 The draft Agreement does not stipulate a voluntary termination of this Agreement.

5 Item 3.1.1 (b) of the draft stipulates provisions on the right of Generators to demand from the Commission Agent the transfer of Commission Agent's right of claim against Suppliers. This wording is not quite correct since the transfer of right of claim, pursuant to Section 17 of the Civil Code of Ukraine shall be a separate agreement to be concluded between entities not connected with each other by obligations in respect of its subject. In our case the Commission Agent shall perform the commission of the Generator and under the commission agreement the Generator shall have the right to demand from the Commission Agent all it received under agreement or all documents connected with non-compliance of the third party and not the right of claim because it shall belong to the Generator unconditionally irrespective of the Commission Agent's wish and result from the essence of the commission itself.

6 The Board Chairman is authorized to manage the Secretariat's activity. This management shall be effected promptly every day. If the Secretariat has no Chairman, it can not perform its very important functions.

7 Glossary does not define the meaning of the term "Market Funds Administrator." If you have any questions or comments of this memorandum, contact us to discuss them in detail.

APPENDIX C

MEMORANDUM

TO M Rachyn, Chief of Energomarket
S Sambur, Head of CRS (Contractual Relations Service)

SUBJECT Draft Bilateral Agreement with Suppliers

We have considered your draft bilateral sale agreement to be concluded between NEC "Ukrenergo" and Generators. Proposed comments result from the previous brief analysis of this draft Agreement.

The proposed draft meets the current legislation and WEM Agreement. However, there are some provisions of this Agreement, which require a separate consideration.

With the aim to settle disputes, which may arise in the future between the parties on the priority of the bilateral Agreement or the WEM Agreement, and to facilitate the consideration of disputes in court, it would be practical to make this Agreement as a supplement to the WEM Members' Agreement, the standard form of which shall be approved by the WEM Board. Otherwise, the following situation may emerge: The WEM Members' Agreement is, as a matter of fact, a complex multilateral agreement, but relations, which arise between Suppliers and the Commission Agent, are built on a bilateral agreement with the participation of many parties.

The bilateral Agreement to be concluded by each Supplier with the Commission Agent separately is also a bilateral agreement. Moreover, this agreement shall be made on the same subject, the same terms and conditions, and the same entities as the WEM Members' agreement. From a legal aspect, this means that these agreements fully coincide. But physically, these will be two agreements with the same subject, terms and conditions, entities, etc., which shall not be valid. Accordingly, one of the agreements shall be considered invalid if concluded without the aim to create legal consequences for its parties (Part 1, Clause 58 of the Civil Code of Ukraine). Pursuant to Clause 15 of the Law of Ukraine "On Electricity Sector", the wholesale purchase and sale of electricity in Ukraine shall be effected through the wholesale market, which, in its turn, shall be created on the basis of the Agreement. The agreement shall stipulate the purpose and conditions of the activity, rights, commitments and

responsibilities of its parties. That is, the WEM Members' Agreement cannot be considered invalid, since laws specify its existence. Thus, one can come to a conclusion that after concluding bilateral separate sale agreements there will be grounds to consider them invalid from the moment of their conclusion.

As far as the Preamble to the Agreement is concerned, it would be practical to add to the objectives specified in the draft the following

with the aim of

working out in detail the provisions of the WEM Members' Agreement in respect of forms and procedure of physical electricity metering,

determining volumes of electricity purchase/sale,

specifying forms and basis of direct settlements,

determining complaints and claims precisely.

Item 8.1 of Section 8 "Other Conditions" of the proposed draft gives the right for Suppliers to re-conclude agreements with customers having specified therein the performance of obligations in favor of the Commission Agent under Clause 160 of the Civil Code of Ukraine provided that the Supplier and the Commission Agent have joint liabilities.

These provisions do not fully meet the current legislation in several aspects.

In the first place, the WEM Members' Agreement regulates the relations between Generators, Suppliers and the Commission Agent. So it shall not specify any obligations for the third parties (customers). Provisions on re-conclusion of agreements between Suppliers and customers can be valid only when customers will wish to terminate the old agreement voluntarily and to conclude a new one or make changes and amendments to the old one. Furthermore, the principle of retrospective action of a law is valid in the civil law. This means that changes and amendments made in agreements shall be effective from the date of signing these changes and amendments by parties. If any customer rejects to re-conclude the agreement with the Supplier, nobody has the right to force this customer to do it. So, this rule of the draft Agreement is not binding for the parties to the Agreement and in no way applies to the customer.

In the second place, Provisions on the conclusion of the agreement in favor of the third party (the Commission Agent) in compliance with Clause 160 of the Civil Code of Ukraine runs counter to the established procedure of settlements. Actually, the Civil Code contains the law, which grants the right to conclude agreements in favor of the third party. However, this agreement for legal entities shall have to be considered invalid as such, which does not meet the law for the following reasons:

Item 5 of Decree of the President of Ukraine No 227/95 of March 16, 1995 On Measures to Normalize the Payment Discipline in the National Economy stipulates that sales proceeds outstanding amounts shall be entered to the same account This shall be understood that if Suppliers sell electricity to customers, then only suppliers, and nobody else shall have the right to receive payments from customers for electricity sold Joint Resolution of the Cabinet of Ministers of Ukraine and the National Bank of Ukraine No 811 of June 5 1998 On Establishment of Special Procedure of Settlements for Electricity Sold to Customers has approved an appropriate Procedure Item 2 of this Resolution stipulates that payments by customers for electricity purchased shall be made solely in the clearing account of the Supplier to be then transferred to the Commission Agent account

It is obvious from the above statements that a condition of making an agreement in favor of the third party contradicts the current legislation

In the third place, Provisions on solidarity of the Commission Agent and the Supplier in the right to claim for performance of payment liabilities from customers also contradict the current legislation Joint claims of creditors may arise out of the law or the agreement Such claims do not arise from the law As to the sale agreement with the customers, it could not be concluded on the stated conditions Such an agreement, if concluded shall specify grounds for joint claims of creditors (that is, the Commission Agent and the Supplier) to the customer One of the grounds shall be the transfer of electricity to ownership of the customer under the agreement by which the sellers shall be the Commission Agent and the Supplier But this contradicts the Law of Ukraine "On Electricity Sector" which stipulates that customers shall purchase electricity solely from Suppliers, and electricity from the wholesale market, i.e, from the Commission Agent, shall be sold solely to entities which hold appropriate licenses for electricity supply

If you have any questions or comments of this memorandum contact us to discuss them in detail