

REGIONAL ECONOMIES

**THE ENERGY SECTOR OF
UZBEKISTAN:
PRESENT STATE AND
PROBLEMS¹**

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**Uzbekistan:
Politics in the Energy Sector**

The entire fuel and energy complex of Uzbekistan belongs to the state: the oil and gas branch is controlled by the National Holding Uzbekneftegaz; coal, by the Ugol firm, one of the companies that make up the State Joint-Stock Company called Uzbekenergo that is responsible for the power production sector. In other words, until recently the fuel and energy complex that remained a vertically arranged and rigidly integrated system it had been under Soviet power was never affected by the market reforms going on in other spheres. Presidential decree No. 2812 of 22 February, 2001 On Deepening Economic Reforms in the Energy Sphere of the Republic of Uzbekistan opened an era of changes in this economic branch.

The Regulatory Agencies

Until recently the regulatory functions in the energy sphere belonged to Uzneftegazinspeksia and Uzenergonadzor that were part of Uzbekneftegaz and Uzbekenergo; as such they could not be independ-

¹ Concluded from *Central Asia and the Caucasus*, No. 2 (32), 2004.

ent. By its decision No. 220 of 8 July, 2000 Cabinet of Ministers removed Uzneftgazinspektsia from Uzbekneftgaz; it was transformed into an independent structure the Uzbek State Inspection for Control over the Use of Oil Products and Gas (Uzgosneftgazinspektsia) at the Cabinet of Ministers. Today it has to address the following tasks:

- Consistent control over the use of oil products and gas in the country;
- Control over the norms and rules related to the quality and quantity of oil products and gas used in economic branches, control over the technological processes and the state of technological equipment used by the oil and gas branch as well as control over observing (by the organizations engaged in building objects in the oil and gas industry) the constructions norms and rules to be used in the process of construction and installation mounting of oil and gas networks;
- Contribution to elaboration and realization of energy-saving measures, programs and projects of the rational use of oil products and gas.

Under the same presidential decree Uzbekenergo lost Uzenergonadzor that was transformed into an independent State Agency for Control over Energy Production called Uzgosenergonadzor. It is accountable to the Cabinet of Ministers that appoints its general director and his deputies. Its tasks were outlined in the Cabinet's Resolution No. 94 of 24 February, 2001 as:

- Elaboration of necessary normative documents and rules of production, transportation and use of power and coal;
- Inspections and expert analysis of how electric energy and heat producers work as well as how consumers use these products;
- Control over compliance with the republic's legislation, normative acts and rules in the sphere of production, transportation and use of energy;
- Organization of licensing (in accordance with the established procedure) of production of electric energy at stationary electric power stations that are part of the unified power grid;
- Elaboration and realization of measures designed to attract foreign investments to the sphere of production and transportation of electric energy, and coal mining;
- Encouragement of competition and ensuring a non-discriminatory open access to transmission grids for all competitors;
- Creating favorable conditions for the development of renewable power sources;
- Creating conditions under which the ecological norms and requirements in the sphere of production, transportation and use of coal and electric energy are observed;
- Control over the balance of production, distribution and use of coal and electric energy.

Main Principles of Reforming the Fuel and Energy Sphere

Many of the developed countries retained state control over the fuel and energy complex; in the last 20 to 30 years they have accumulated considerable experience in reforming the branch and creating conditions for competition in it. When summarizing this experience R. Pritchard and P. Andrews-Speed² have formulated eight principles of reforming the energy sphere:

² See: R. Pritchard, P. Andrews-Speed, "Eight Principles of Electricity Industry Reform," *International Energy Law and Taxation Review*, No. 1, 2001, pp. 11-17.

- Separation of economic and state administration functions;
- Creation of a wholesale market of energy sources;
- Guaranteed access of power producers to the distribution systems;
- Creation of an independent regulatory agency;
- Legislative back-up of the reforms;
- Careful approach to independent projects;
- Admission of private property to the energy sector;
- Creating public support for these plans.

Let us discuss these principles as applied to Uzbekistan.

Separation of Economic and State Government Functions

An analysis of tasks and functions of the state structures Uzbekneftegaz and Uzbekenergo shows that their functions can be described as state government functions. The most important among them are:

- Elaboration of short- and long-term forecasts and purpose-oriented programs of the branch's development and balances of production and consumption;
- Regulation of prices and tariffs in the sphere of energy sources and power;
- Identification and coordination of strategic and priority trends in prospecting for oil, gas and coal;
- R&D in the sphere of renewable and non-traditional energy sources;
- Elaboration and introduction of measures designed to save energy sources and use them rationally, as well as decrease losses of gas, coal, and electric power;
- Control over the systems of power and gas supply;
- Attraction of foreign investments.

The other tasks belong to the sphere of economy and are found outside the scope of the present article; they should be addressed by other state agencies such as the Energy Agency. Division of the functions of the vertically integrated monopolies (Uzbekneftegaz and Uzbekenergo) also belongs to the sphere of structural reforms that the branch badly needs: the functions should be divided into extraction (generation), transmission and distribution.

Creation of a Wholesale Market of Energy Sources

The wholesale market cannot function unless the sphere acquires independent producers. This means that firms independent from Uzbekenergo should be set up; in their activities they should follow the logic of the market. The republic has already launched certain changes: public corporations are set up in the spheres of generation and distribution of electric energy.³ The situation in the oil and gas sphere is much more complicated. I have demonstrated in the first part of my article that appeared in the previous issue

³ See: Neftegazovaia promyshlennost. Uzbekneftegaz [www.uz/eng/industries/ung.htm], 19 March, 2003.

of this journal that the oil and gas national holding comprises seven major production joint-stock companies. Each of them has daughter companies and is a monopolist in its sphere. Competitive environment in the oil and gas extraction requires that this national holding should be divided into two or three more or less equal companies. The same applies to Uznefteprodukt (it has branches in all regions of the country). The larger part of the filling stations in the republic is privately owned, yet there is no competition in the sphere of distribution, which means that the monopoly of one company is not conducive to higher quality of its products. It seems that Uznefteprodukt should be divided into several firms to function at least in half of the regions. There are three oil refineries in the republic; in order to create competitive environment in this sphere as well each of them should serve as a core of a joint-stock company. The state should retain its control over Uztransgas so as to ensure equal access of mining companies to oil and gas fields. Other companies serve the above-mentioned structures and do not need restructuring.

Guaranteed Access of Power Producers to Distribution Systems

Equal access to the power transmission and distribution systems is the key issue of the market of power and gas. This should be legally registered. According to Pritchard and Andrews-Speed, a Code of Access to the Transmission and Distribution Network elaborated by an independent regulatory structure is the most effective instrument.⁴ To attract private investments to power and gas main lines and to encourage investors the code should ensure return of investments. This can be achieved by creating a stimulatory system of price formation so as to balance the interests of network owners and consumers; the pricing mechanisms should allow network owners to increase their profits together with more efficient work. In Uzbekistan the controlling interest should belong to the state: in Uztransgas and in the Unified Power Grid of Central Asia (within the republic).

Creation of an Independent Regulatory Agency

Government has a special role to play in defining the tasks of national energy policy and regulating its implementation. It should try to avoid any hampering interference; in the same way the state should avoid any interference that might negatively affect an effective distribution of resources or adjustment to changes. This means that the government should make state structures responsible for entering the market, accession to networks, price formation, service standards and protection of the rights of consumers. In other words, the state should concentrate on making regulatory structures financially and politically independent of the state and of electric power and gas suppliers. Economic expediency should be regarded as the key issue. There is any number of works dealing with the main conditions that create an independent regulator.⁵ I have discussed the main tasks the regulators should deal with in the sphere of fuel and energy complex. They are of technical, controlling and supervisory nature mainly adjusted to the requirements of centralized planned economy. In the market conditions these structures have to address

⁴ See: R. Pritchard, P. Andrews-Speed, op. cit.

⁵ See, for example: J. Stern, "What Makes an Independent Regulator Independent?" *Business Strategy Review*, Vol. 8, No. 2, 1997, pp. 67-74; idem, "Utility Reform, Privatization and Regulation: Lessons from Central and Eastern Europe and from China," *International Business Lawyer*, Vol. 27, No. 11, 1997; J. Stern, J.R. Davis, "Economic Reform of the Electricity Industries of Central and Eastern Europe," *Economics of Transition*, Vol. 6, No. 2, 1999, pp. 427-460; D. Kennedy, "Competition in the Power Sector of Transition Economies," *Working Paper No. 41*, European Bank for Reconstruction and Development, London, 1999; idem, "Regulatory Reform and Market Development in Power Sectors of Transition Economies: The Case of Kazakhstan," *Energy Policy*, Vol. 30, No. 3, 2002, pp. 219-233; idem, "Liberalization of the Russian Power Sector," *Energy Policy*, Vol. 31, No. 8, 2003, pp. 745-758.

different tasks: they have to influence the economic entities by elaborating legislative initiatives in the sphere of economy (taxes, tariffs, and prices established for long-term periods). Today, these problems belong to the Ministry of Finance, the State Tax Committee, Uzbekneftegaz and Uzbekenergo the decisions of which are of fiscal nature alone. This explains why unless the status of Uzgosneftegazinspektsia and Uzgosenergonadzor is changed they will not become independent regulatory structures which the budding market economy badly needs.

Legislative Back-up of Reforms

In its reviews of privatization in the electric power and gas sphere in Hungary and Kazakhstan the World Bank pointed out that Hungary had scored greatest successes in reforming the fuel and energy complex among all former socialist and CIS countries.⁶ During the preparatory period the country carried out the following measures: its fuel and energy complex was divided into independent companies; in 1991-1992 the vertical administrative ties among them were replaced with contracts; the branch received a legal basis and a regulatory regime; the price formation mechanisms and principles were registered by laws. By 1994-1995 the country obtained a privatization strategy; the government abandoned its administering role and limited itself to its share of property in the energy transmission systems and to the nuclear power. Today, private sector is mainly responsible for the fuel and energy complex.

The reforms received legal back-up in the form of 150 new laws and resolutions of the Cabinet of Ministers, ministries and departments. The larger part (101) of the newly adopted laws and normative acts dealt with privatization of the objects of energy production and gas sectors, the rates of price rises and terms under which prices could be raised, more effective use of energy, regulation of prices and tariffs with participation by consumers, and compensations to the latter.

The government of Uzbekistan has already adopted at least 82 relevant documents, yet the number of those dealing with the issues enumerated above is much smaller. I have already noted that today the state-owned companies Uzbekenergo and Uzbekneftegaz remain uncontested monopolies in their spheres.

Careful Approach to Independent Projects

Normally independent energy projects are realized according to one of two patterns: construction-ownership-exploitation (COE) and construction-exploitation-transfer (CET). Because of inadequate institutional back-up of both patterns they are rarely used.⁷ In fact they are better suited for the countries with a developed competitive environment. To use these patterns with any degree of efficiency five of the above principles should be realized.

Admission of Private Property to the Energy Sector

Private property can and should be allowed in the sphere of energy production and distribution. To reach this goal the state should separate the regulatory and the economic functions in such monopolies as

⁶ See: "Privatization of the Power and Natural Gas Industries in Hungary and Kazakhstan," *Technical Paper No. 451*, World Bank, Washington, 1999.

⁷ See: R. Pritchard, P. Andrews-Speed, op. cit.

Uzbekneftegaz and Uzbekenergo. Then they should be divided into independent production companies. When private sector comes to these spheres the state-owned companies will have to compete not among themselves but with private firms under strict control of regulatory agencies.

Creation of corporations is a process in which state property in the fuel and energy complex is transformed into enterprises or companies with state property (CSP). Such companies are completely free of political control (though the main shareholders can influence their policy by appointing or removing directors). This process presupposes the following inevitable features:

- Adaptation of individual administrative structures;
- Appointment of nominally independent members to the CSP boards of directors;
- Limitation of powers and responsibilities of the CSP to a certain range of economic issues so as to prevent unsanctioned initiatives in the sphere, and performance of state administering functions that do not belong to them;
- Achievement of complete transparency of the results of their performance as well as their independent creditability;
- Creation of conditions in which CSP are responsible solely for their economic performance;
- Transformation of the bureaucratic hierarchical management system into a system that pays particular attention to the delegation of powers and accountability.

When the process is complete the CSP will have to meet the same criteria as those applied to the private sector (this is what so-called competitive neutrality is about).

Privatization of the CSP should make them completely independent and remove any need for competitive neutrality. Before any of the CSP is sold their finances should be restructured. In many of the developing countries such companies accumulated debts; their further functioning, however, depends on investment decisions rooted in political or social considerations.

In all cases structural and regulatory reforms should predate privatization so as to make the companies transparent and completely understandable for future investors. Regrettably, in Uzbekistan no corporations had appeared before privatization began in a total absence of any necessary indispensable structural and regulatory reforms. The larger part of the transformed ministries, departments and agencies preserves the tasks and functions they inherited from the Soviet planned economy.

Creating Public Support for These Plans

Public support is one of the keys to success; it predetermines success. For many reasons, however, governments are often deprived of this important instrument: more often than not the public doubts sincerity of many initiatives. There are several ways leading to a wide public involvement in decision-making: population should receive part of the shares of the fuel and energy sector; the public should be invited to contribute to planning the use of land; the regulatory structures should be accountable to the public organizations.

C o n c l u s i o n s

An analysis of the state of the fuel and energy sector of Uzbekistan suggests the following conclusions.

The republic has everything it needs to reach economic stability with the help of its fuel and energy resources and the industrial basis of fuel extraction and generation of power.

The reforms of the fuel and energy complex launched in 2001 designed to supplant the command administrative methods with market regulation have not yet gained momentum.

So far, there is no program and no clear ideas about the stages and order of the necessary structural changes because such programs and draft laws are drawn by the ministries and departments resolved to protect their narrow corporate interests that have nothing to do with the needs of the state and society as a whole.

The country needs a theoretical basis for such transformations that should reflect the principles discussed above; it should address the tasks of setting up independent state regulatory structures; of formulating the principles of price formation, tariffs, taxation and other aspects designed to limit the state's direct involvement in economic activities of both companies with state and private property.