

3 Main energy pricing and energy taxation policies in the Eastern Partner countries

This chapter focuses on the main energy pricing and energy taxation policies in the six European Union's Eastern Partner (EaP) countries (Armenia, Azerbaijan, Belarus, Georgia, Republic of Moldova and Ukraine) with direct or indirect impact on the evolution of fossil-fuel subsidies. It also reviews the main macroeconomic trends that characterise the economies of these countries in light of the most recent developments caused by the COVID-19 crisis. Finally, it discusses the energy mix and energy productivity of the EaP economies, as well as recent changes in the energy pricing and taxation policies and their significance for the reforms of fossil-fuel subsidies.

Macroeconomic trends

The European Union's Eastern Partner (EaP) countries (Armenia, Azerbaijan, Belarus, Georgia, Republic of Moldova and Ukraine) differ in the size of their population and economy, as well as level of economic development.¹ Ukraine is by far the largest of the six economies with 2018 gross domestic product (GDP) at USD 130.8 billion. It is followed by Belarus and Azerbaijan, with GDP at USD 59.7 billion and USD 46.9 billion, respectively. Georgia, Armenia and the Republic of Moldova (hereafter "Moldova") are the smallest economies (Table 3.1). In 2018, however, Belarus and Azerbaijan had the highest GDP per capita – approximately USD 20 000 and USD 18 000 (current international USD, purchasing power parity – PPP), respectively (Table 3.1). Armenia and Georgia had the highest GDP growth rate in 2018.

The population of the EaP countries was around 73.4 million people in 2018. All EaP countries were affected by the coronavirus pandemic in 2020. At the time of the writing of this report, they were revising their short-term macroeconomic forecasts and budget spending.

Table 3.1. Key economic indicators of EaP countries in 2018

	Population, million	GDP growth rate, percentage	GDP, billion current USD
Armenia	3.0	5.2	12.4
Azerbaijan	9.9	1.5	46.9*
Belarus	9.5	3.1	59.7
Georgia	3.7	4.8	17.6
Moldova	2.7	4.3	11.4
Ukraine	44.6	3.3	130.8

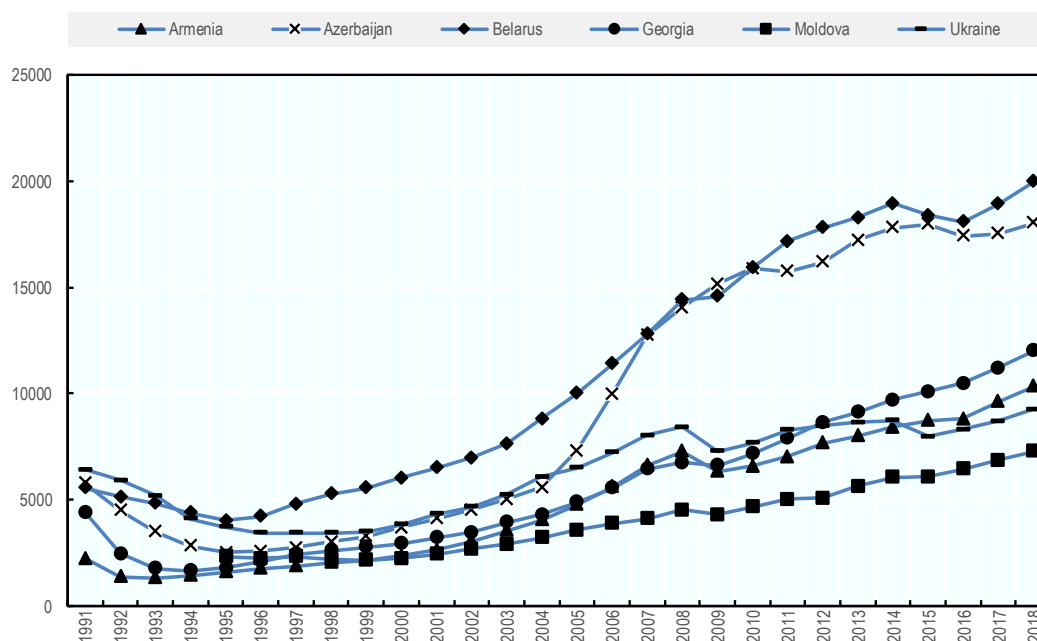
Note: *According to national statistics (as communicated by the Ministry of Economy of Azerbaijan), GDP in Azerbaijan in 2018 amounted to USD 47.1 billion.

Source: World Bank (2020_[1]).

To ensure cross-country comparisons, this chapter relies on *World Bank Open Data* and other sources of international statistics. Exchange rates of the national currencies in the six countries have been volatile over 1991-2019. National currencies of most countries in the region depreciated against the US dollar in 2015, shrinking their GDP in dollar terms even when the economy grew in real terms (Annex A).

Despite many differences, the six countries share several common strengths, including a highly educated workforce and the continued opening of their economies to trade and investment opportunities. Armenia, Georgia, Moldova and Ukraine are World Trade Organization (WTO) members, while Azerbaijan and Belarus are negotiating their accession. As of March 2017, all six EaP countries had signed the European Union (EU)-led Energy Charter Treaty to support energy trade and investment.² They all later ratified it, except for Belarus, which applied the treaty provisionally (IEC, n.d._[2]). Armenia and Belarus are also members of the Eurasian Economic Union (EAEU)³ and its Customs Union, which provides for further integration of the countries' energy systems.

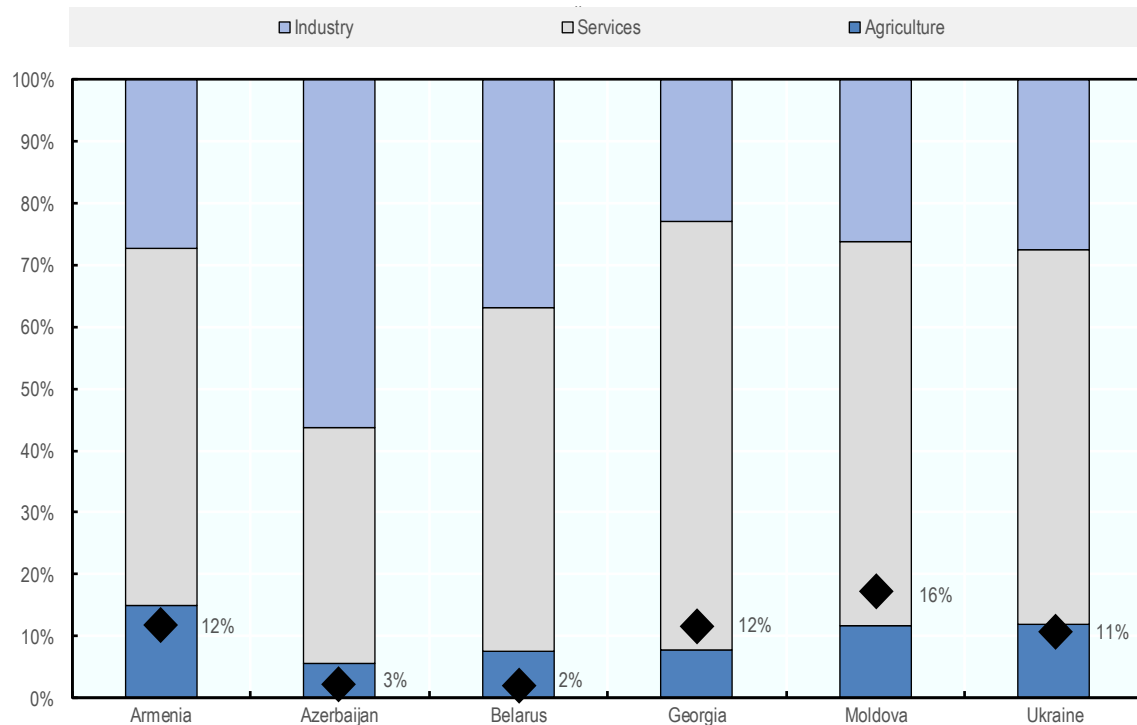
Figure 3.1. GDP per capita, purchasing power parity, current international USD



Source: World Bank (2020_[1]).

The EaP countries share a common macroeconomic pattern. GDP decreased sharply in the years after the collapse of the Soviet Union in 1991. This was followed by restructuring and modernisation of their economies and restoration of economic growth in the late 1990s and 2000s. Overall, from 1991 to 2018, the six EaP economies have all grown in real terms (World Bank, 2020_[1]). All EaP countries developed a large service sector that contributed to over third of the value-added in each country (Figure 3.2). Meanwhile, personal remittances constitute a considerable share of the GDP – more than 10% in most countries except Azerbaijan and Belarus (Figure 3.2).

Figure 3.2. Structure of the economy and personal remittances received, share of GDP, 2018



Note: In this figure, remittances as a share of GDP are indicated by the black diamond.

Source: World Bank (2020^[1]).

The six countries' economic performance is sensitive to fluctuations in international commodity markets⁴ and regional linkages. All EaP countries experience fiscal pressures: central budget deficits ranged from 0.3% in Azerbaijan to 1.9% in Ukraine. Meanwhile, Belarus was the only country with a budgetary surplus (4%) in 2018 (Eurostat, 2019^[3]).

The COVID-19 crisis significantly aggravated the economic performance of the EaP countries in 2020. The health crisis has triggered an economic crisis, which is turning into a global recession. The pandemic has brought about a collapse of commodity prices, tourism, remittances and exports, as well as supply chain disruptions and financial market confusion. COVID-19 has exposed countries' vulnerabilities and lack of preparedness to fight major crises.

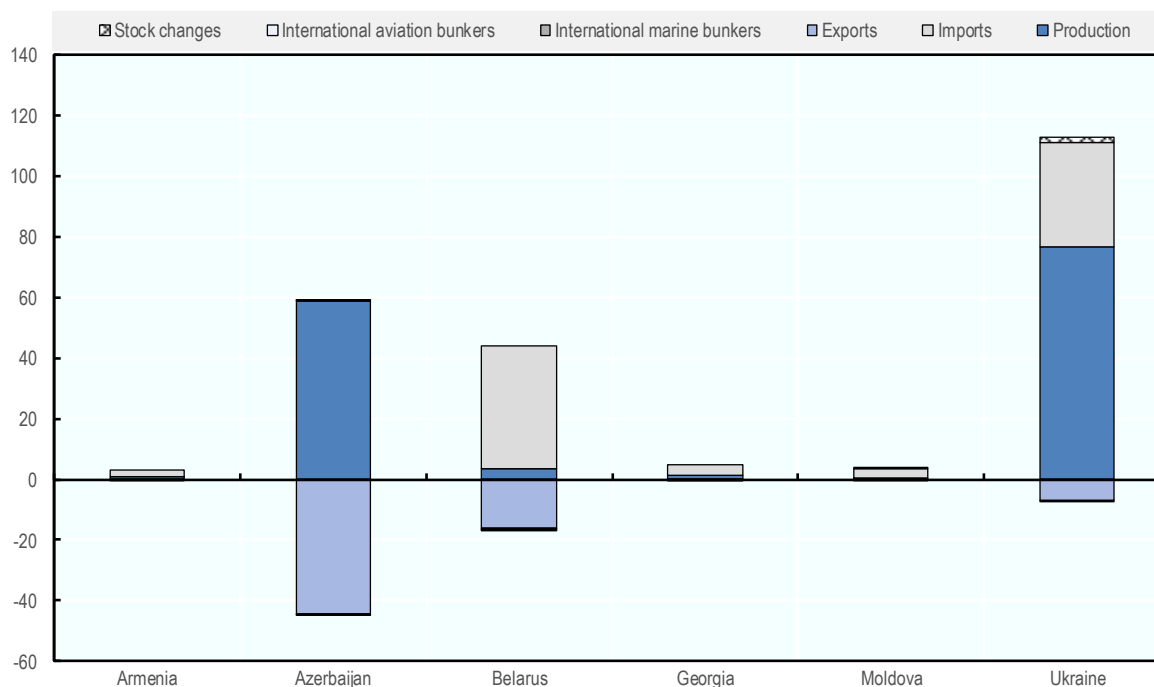
According to the International Monetary Fund (IMF, 2021^[4]), real economic growth in the EaP region contracted on average by 5.1% in 2020. Armenia and Moldova experienced the deepest economic downturn (-7.8% and -7.5%, respectively), followed by Georgia (-6.1%). Azerbaijan and Ukraine did somewhat "better" (-4.3% and -4.2%, respectively). Real economic growth in Belarus contracted year-on-year in 2020 by 0.9%. Growth in the region is forecast to rebound in 2021, as global commodity prices gradually recover, trade strengthens and domestic demand improves. However, many uncertainties remain.

Energy mix and energy productivity

In the political and economic transition from central planning to market orientation, the energy systems of the EaP countries have undergone several waves of reforms and restructuring. These changes, still in progress, are subject to several key drivers.

Except for Azerbaijan, the EaP countries are net energy importers (Figure 3.3). Thus, energy security is a major issue for most countries in the region. The Russian Federation (hereafter “Russia”), Azerbaijan and, to a certain extent, the Central Asian states (such as Kazakhstan, Turkmenistan) are key energy suppliers. Increasingly, the EaP countries are set to leverage their strategic position. On the one hand, Russia and Central Asia export energy. On the other, the European Union and the People’s Republic of China are major markets for natural gas and oil.

Figure 3.3. Total energy supply of EaP countries in 2017, mtoe



Note: mtoe – million tonnes of oil equivalent.

Source: IEA (2020^[5]).

Fossil fuels continue to dominate the region’s energy sector. Except for Ukraine, the share of natural gas in the total primary energy supply has increased in the region at the expense of fuel oil. There are several drivers behind this trend. For example, Azerbaijan has increased its own production of natural gas. Meanwhile, Belarus, Armenia, Moldova and to a certain extent Georgia, have access to affordable imports of natural gas, mainly from Russia. These countries also introduced market pricing for oil products following the collapse of the Soviet Union. Box 3.1 provides more details on the energy mix in individual EaP countries.

Box 3.1. Energy mix in EaP countries

Armenia has no domestic resources of fossil fuels. It relies on domestically generated electricity and imported natural gas to meet most of its energy consumption needs. Imported natural gas dominates the total energy supply (TES) in Armenia. It accounts for 61% of Armenia's TES and 85% of the fossil-fuel (including jet fuel) consumption in 2017.

Azerbaijan is rich in deposits of oil and natural gas and has, over the last decade, become a major energy producer. As of 2019, total proven reserves of oil and natural gas amount to 7 000 million barrels and 2.1 trillion cubic metres, respectively. Oil production stood at 39.2 million tonnes⁵ in 2018, roughly 24% less than the peak of 51.3 million tonnes in 2010. In 2017, natural gas and oil constituted 64% and 35% of TES, respectively.

Belarus is a net energy importer whose domestic sources covered only 15% of TES. The country relies heavily on imported natural gas and oil for power production (97% gas-fired generation). Its export-oriented refining and petrochemical industry exported about 13 million tonnes of oil equivalent (mtoe) of oil products in 2017. This was an important source of hard currency for the country.

Georgia is a net importer of energy. It relies heavily on natural gas imports from Azerbaijan, and various imports of oil products and coal. The country's domestic energy production centres around hydropower, biomass and some coal. In 2017, natural gas and oil accounted for 41% and 30% of TES, respectively, while the share of hydropower was 16%.

Moldova depends highly on energy imports, as domestic production (mostly biofuels and waste) accounted for approximately 21% of supply in 2017. Moldova imports natural gas, oil products, coal and electricity and the former two energy carriers constituted 51% and 23% of TES, respectively. Moldova began construction of the Ungheni-Chişinau pipeline (120 km) in 2018 to diversify gas supplies from Russia and to connect with the European gas market. Completion is planned for 2021 at a cost of EUR 70-90 million.

In 2017, domestic production covered 66% of TES in **Ukraine** with the largest shares from nuclear (22.4 mtoe), natural gas (15.5 mtoe) and coal (13.7 mtoe). In the same year, power plants and combined heat and power (CHP) plants used roughly a third of energy supply to generate 156 terawatt hours (TWh) of electricity. Nuclear and coal-fired power plants contributed 54% and 32% to the electricity generation mix, respectively.

Source: Based on IEA (2020^[5]) data.

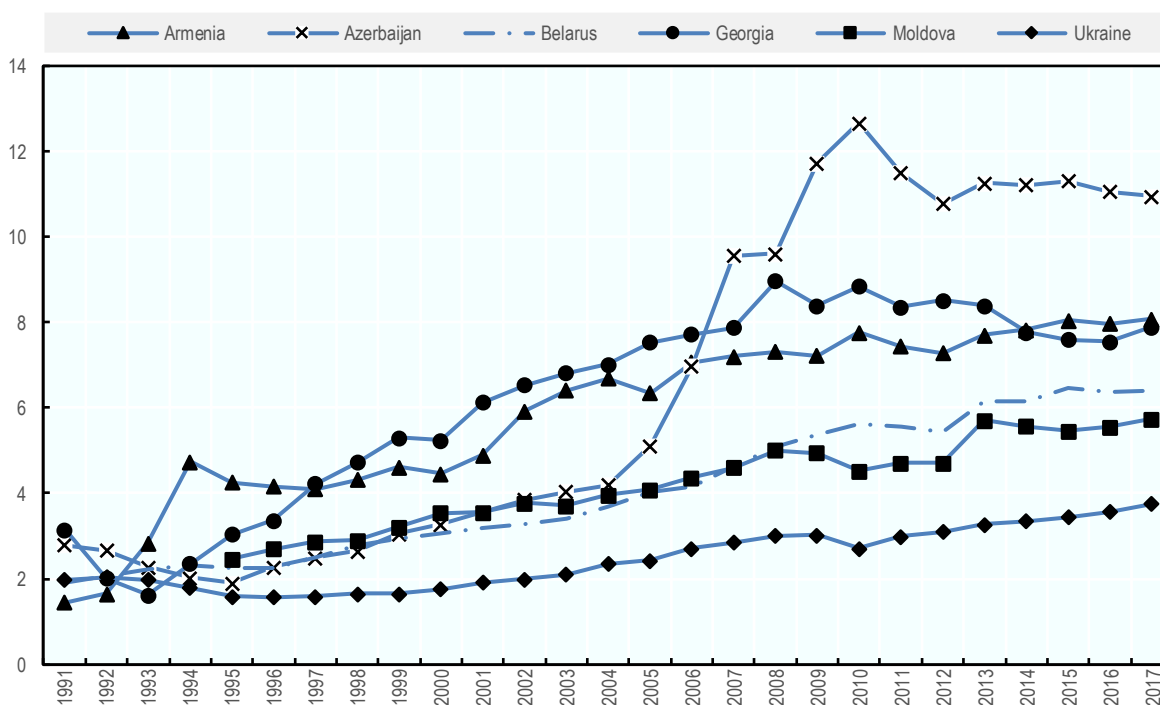
Renewable energy plays a negligible role in the region, except for significant hydropower generation in Georgia. Belarus, Ukraine and Moldova also produce biomass and biofuels for energy use, while Armenia and Ukraine generate nuclear power. Belarus is completing the construction of its first nuclear power plant (the launch of the first unit was postponed several times).

The transition from a centrally planned to market economy has coincided with lack of revenue and capital for infrastructure maintenance and modernisation and the need for new funding sources. The assets built in Soviet times are still the backbone of the energy infrastructure in the EaP countries. As a result, the region's economies are still highly energy-intensive. Figure 3.4 shows that each of the EaP countries produced more dollars of GDP in 2017 than in 1990 per unit of energy consumed.

Some productivity gains have been made, but performance has been uneven across the EaP countries. Azerbaijan is in a unique position as an energy exporter. Since 1990, Armenia has led the region with a

more than fivefold improvement of energy productivity of GDP. Meanwhile, Ukraine has only improved its energy productivity by 1.8-times, only slightly more than half the progress made by Belarus.

Figure 3.4. Energy productivity in EaP countries, GDP per unit of energy use, constant 2011 PPP USD per kg of oil equivalent



Source: Estimated indicator based on World Bank (2020_[11]) and IEA (2020_[5]).

Key energy pricing policies

Energy pricing is highly regulated in the EaP countries. The most commonly used term for an energy pricing policy in the region is “tariff regulation”. Energy price liberalisation remains socially and politically sensitive because price regulation is still considered important to protect socially vulnerable households, support industrial competitiveness and restrain inflation. Some countries have abandoned “blanket” subsidies provided through low tariffs for more targeted support schemes.

Table 3.2 provides an overview of the key characteristics of energy pricing policies in each country.

Table 3.2. Key characteristics of energy pricing policies in EaP countries as of end 2019

	Armenia	Azerbaijan	Belarus	Georgia	Moldova	Ukraine
Price-setting authority	Public Services Regulatory Commission	Tariff Council	The Council of Ministers, Ministry for Anti-Monopoly Regulation and Trade	Georgian National Energy and Water Supply Regulatory Commission	National Energy Regulatory Agency	National Energy and Utilities Regulatory Commission, Cabinet of Ministers of Ukraine
Natural gas	Regulated prices	Regulated prices	Regulated prices, cross-subsidies	Mostly regulated prices, elements of both cross-subsidies and deregulation	Regulated prices	Regulated prices for households, deregulated prices for industry
Electricity						Regulated prices, cross-subsidies
Heat	n.a.			n.a.		Regulated prices
Liquid petroleum products	Deregulated prices		Regulated prices	Deregulated prices		
Coal and other solid fuels						

Note:* n.a. – Not applicable.

Source: Adopted and updated from from OECD (2018^[6]).

Except for Belarus, where energy prices for the population are set by the Council of Ministers and for legal entities - by the Ministry for Anti-Monopoly Regulation and Trade (except for heat generated by entities outside of the “Belenergo” State Production Association), all other EaP countries have set up dedicated bodies for energy tariff-setting. The degree of independence enjoyed by these new institutions varies across countries and periods between the waves of reforms. Interference from governments and state-owned energy companies in tariff setting has been quite common. Consequently, the recovery of costs in the energy sector continues to be lower than it could be.

The natural gas, heat and electricity sectors remain subject to price regulation in all EaP countries, for consumers as well as often for producers. Different groups of consumers and producers normally have different tariffs. Formally, price-setting methodologies for most energy types are publicly available and, at least in theory, based on the “cost-plus” methodology. However, the cost-recovery concept is often limited to operational costs. It is insufficient to recover long-run investment and modernisation expenditure. The market for liquid petroleum products is the most deregulated segment in the region; only Azerbaijan and Belarus regulate prices in this sector.

Pricing policies, including methodologies, tariff structures and regulations, continue to evolve in the EaP region. For example, the Georgian National Energy and Water Supply Regulatory Commission, in line with international standards in electricity and gas sectors, has abandoned tariff setting based on memoranda. Its tariff regulation is completely subject to the Commission's normative acts (tariff methodologies).

In 2018, Moldova decreased electricity and natural gas tariffs by 10% and 20%, respectively, in response to currency appreciation; tariffs for heating remain unchanged.

On 2 December 2013, the Tariff Council of Azerbaijan announced an increase of state-regulated price ceilings for gasoline, diesel and natural gas for industrial facilities. This resulted in price increases for petroleum products of about 27-33% and almost 50% for natural gas. This decision – the first adjustment since 2007 – was apparently taken to compensate for the loss in government revenue due to the decline in oil production⁶ (RFE/RL's Azerbaijani Service, 2013^[7]). In previous years, Tariff Council proposals for tariff increases were cancelled following interventions from the Azerbaijani Presidency.

The government of Ukraine implemented a substantial increase of utility tariffs in 2014-17 and further reformed pricing policies. This helped reduce the deficits of utility providers and consequently cut or eliminated various government compensation schemes. Rather than keeping low tariffs for all households for social and political reasons, the government has also gradually reformed its social support programmes to target eligible low-income households (Box 2.3).

Compared to the first EaP Inventory (OECD, 2018^[6]) relatively little has changed in the energy pricing policies in the EaP countries. Gas price reform lies at the heart of the energy sector and fossil-fuel subsidy reforms in the region. Among the EaP countries, Ukraine has implemented some of the most significant pricing reforms in recent years. These include, among others, increasing tariffs for the population to levels closer to cost recovery of gas, electricity and heat supply; eliminating regulated tariffs for industrial users and recently natural gas tariffs for households;⁷ and strengthening targeted social support programmes for poor people. The real challenge for the country is to ensure that new governments do not abandon these reforms but rather further improve them.

The COVID-19 crisis and lower international energy prices coupled with reduced energy demand open up yet another window of opportunity for the countries in the region. They may wish to re-assess their energy pricing policies, depoliticise them (e.g. introduce price adjustment formulae) and consider adequate measures to protect the vulnerable segments of the population.

Main taxation policies

In the past two decades, the EaP countries have made efforts to reform their fiscal systems to reduce administrative barriers, simplify taxation and thus increase collection of tax revenue. Baseline taxation in all EaP countries includes value-added tax (VAT), corporate profit tax, individual income tax, property tax, land tax and a single tax for small businesses – all codified at the national level and passed into law.

Most countries also charge additional local taxes, a road tax on vehicles and fees for environmental pollution. Belarus applies a lowering 0.27 coefficient to environmental tax rates on certain emissions. The rate applies on emissions generated from fossil-fuel combustion by power plants that provide electricity and heat for households and social service institutions in health care, tourism and sports, education and culture (National Assembly of the Republic of Belarus, 2002^[8]).

In the extractive sector, the three countries with scalable production of fossil fuels – Azerbaijan, Belarus and Ukraine – charge a mining tax on their production, which is differentiated by type of deposit. Azerbaijan and Georgia also have special taxation regimes for large-scale energy projects implemented by foreign investors such as oil and gas extraction and pipelines. These operate under the so-called Production Sharing Agreements and Host Government Agreements.

The import and export of energy products are subject to customs duties. Consumption of petrol and diesel in all EaP countries is also subject to an excise tax. Liquefied petroleum gas (LPG) and compressed natural gas (CNG) are also excise goods in most EaP countries (Table 3.3). To encourage use of LPG and CNG, many EU countries charge a lower excise rate for these fuels than for petrol or diesel. Among the EaP countries, only Armenia has applied this practice.

Governments determine excise tax rates. They revise the rates relatively often to reflect energy price fluctuations on international markets and to raise sufficient funds for national budgets. Azerbaijan, Belarus and Ukraine differentiate excise tax rates depending on the grade of petrol and diesel. For their part, Armenia, Georgia and Moldova have single excise tax rates for both petrol and diesel. Only Ukraine levies an excise tax on electricity. Natural gas and thermal energy are not subject to excise taxes in the EaP countries.

Excise fuel taxes are often seen as an implicit carbon price. They are similar to carbon prices in that the tax liability increases proportionally to fossil-fuel use. However, this is not a consistent carbon price across all fuels; the excise tax is applied only to some fuels. Reforming fuel excise taxes to better align with the climate costs of fuel use would be administratively straightforward (OECD, 2021^[9]).

VAT and excise taxes form part of the end price for energy goods. Thus, they exist within the wider context of energy price regulation in the EaP countries (see section on Key energy pricing policies). The EaP governments use tax exemptions and adjustments in excise tax rates as tools to adjust consumer energy prices. For example, Armenia had a VAT exemption for diesel imports until the end of 2017. Additionally, tax breaks are used to promote investment in the energy sector in the region (see Chapter 2, section on Budget transfers and revenue foregone).

No EaP country except Ukraine has an explicit carbon tax. Ukraine introduced a carbon price with the approval of the new Tax Code in 2010. The carbon tax on stationary sources of pollution had initially a low rate, but it was increased to UAH 10/tCO₂ (USD 0.4/tCO₂) in 2019 (Parliament of Ukraine, 2010^[10]). In April 2021, the Ministry of Finance submitted to Parliament a draft law informally known as the “Resources Law” (Parliament of Ukraine, 2021^[11]). Among other things, this draft law envisages an increase of the carbon tax rate from UAH 10/tCO₂ to UAH 30/tCO₂ (USD 1.08/tCO₂) (Interfax-Ukraine, 2021^[12]).

The Ukrainian government understands that a carbon tax of USD 1 or below will have little impact on energy prices. As the carbon tax rate in Ukraine is still low relative to fossil-fuel prices and compared to the cost of many CO₂ reduction technologies, it primarily fulfils a fiscal function. However, despite its low rate, the tax is gaining in significance across local businesses. It also has the potential to mobilise additional resources that could be allocated to support new green investments in the country.

Armenia is the only other country in the region that has expressed interest in a carbon tax. The government of Armenia committed to a carbon tax in its Nationally Determined Contribution, which was prepared for the Paris Summit on Climate Change in 2015. However, the document has no specific timing for introducing such a tax. Both Armenia and Ukraine are considering the possibility to use the carbon tax revenue to finance climate change mitigation and adaptation projects.

OECD countries commonly use EUR 30 per tonne of CO₂ as their benchmark carbon rate. This is the low-end estimate for the carbon price needed in the near term for consistency with the net-zero CO₂ emission targets (OECD, 2021^[9]). This price is expected to rise to EUR 120 in the 2030s. Supporting such a trajectory, in May 2021, the EU carbon price went above EUR 50 per tonne of CO₂ for the first time, reflecting market expectations for policy triggers to incentivise investments in innovative clean technologies.

The impacts of carbon pricing on energy prices are of particular concern as they affect the distributional burden on households and industries. A recent study of several countries (IMF/OECD, 2021^[13]) estimates that increasing the carbon tax up to the level of USD 50 per tonne of CO₂ in 2030 will significantly increase their electricity prices. For example, such a tax increase would likely raise electricity prices in Indonesia by 75%, in Russia by 65%, in South Africa by 61%, in Turkey by 60% and in Mexico by 58%.

The impact on electricity prices will depend on the countries’ mix of power generation fuels. The impact of carbon price on coal (given its high carbon intensity) and gas will be considerable but will be smaller on pump prices for motor fuels. Therefore, the implications of a higher carbon tax to encourage decarbonisation of the economy should be well understood and accompanied by incentives to ensure affordable access to cleaner alternatives.

Table 3.3. VAT and excise tax rates on energy consumption in EaP countries

	Armenia	Azerbaijan	Belarus	Georgia	Moldova	Ukraine
Petrol						
VAT rate	20%	18%	20%	18%	20%	20%
Excise rate	Not differentiated by grade	Differentiated by grade	Differentiated by grade	Not differentiated by grade	Not differentiated by grade	Differentiated by grade
Diesel						
VAT rate	20%	18%	20%	18%	20%	20%
Excise rate	Not differentiated by grade	Differentiated by grade	Differentiated by grade	Not differentiated by grade	Not differentiated by grade	Differentiated by grade
CNG						
VAT rate	20%	18%	20%	18%	20%	20%
Excise rate	Yes	Yes	Yes (if used as motor fuel)	Yes	No	Yes
LPG						
VAT rate	20%	18%	20%	18%	8% for households only, 20% for other users	20%
Excise rate	Yes	Yes	Yes (if used as motor fuel)	Yes	Yes	Yes (exemption on sales for households at specialised auctions)
Natural gas						
VAT rate	20%	18%	20%	18%, VAT exemption for natural gas imported for thermal power stations	8% for households only, 20% for other users	20%
Electricity						
VAT rate	20%	18%	20%	18%	0% for households, 20% for other users	20%
Excise rate	No	No	No	No	No	3.2%
Heat						
VAT rate	20%	18%	20%	18%	0% for households, 20% for other users	20%

Source: Adopted and updated from OECD (2018^[6]).

The taxation regime in the energy sector in the EaP region has not changed much since the analysis of the first Inventory covering 2010-15. Except for Ukraine, the EaP countries do not use carbon pricing. Yet carbon pricing provides across-the-board incentives for firms and households to reduce carbon-intensive energy use and shift to cleaner fuels. It also provides the essential price signal for mobilising private investment in clean technologies while raising government revenue (IMF/OECD, 2021^[13]). In this context, Ukraine's experience will provide valuable lessons. However, before introducing such a tax, the EaP governments need to understand its implications on energy prices in their countries.

The recovery packages related to COVID-19 provide an opportunity to reset countries' economies in a greener, more resilient and inclusive way. The EaP governments should use this opportunity to ensure these packages reflect their green and climate ambitions. Fossil-fuel subsidy reform, including energy pricing and taxation, offers key policy measures to support green economic development. Such measures maintain climate commitments while generating revenue to finance pressing social needs.

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[1]

Notes

¹ Data from international sources are used throughout this chapter to ensure accurate cross-country comparisons.

² The Energy Charter Treaty establishes a framework for international co-operation between the European countries and other industrialised countries. This aims to develop the energy potential of Central and Eastern European countries and ensure security of energy supply for the European Union. To that end, countries would operate more open and competitive energy markets, while respecting the principles of sustainable development and sovereignty over energy resources. Key provisions concern protection of investment, trade in energy materials, and products, transit and dispute settlement.

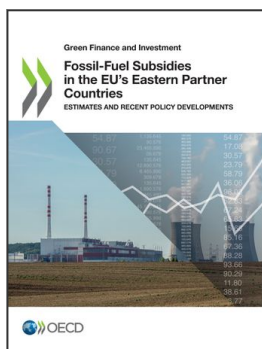
³ The Eurasian Economic Union (EAEU) is a free trade agreement that came into being in 2015 to increase economic cooperation and raise the standard of living of its members. Member countries include Russia, Armenia, Belarus, Kazakhstan, and Kyrgyzstan. Unlike the European Union, the EAEU does not share a common currency.

⁴ Especially in the case of Azerbaijan, the only exporter of energy commodities in the region or in the case of Armenia where mineral exports make up a significant share of the country's exports.

⁵ According to national statistics from the Ministry of Economy of Azerbaijan, oil production in Azerbaijan in 2018 was 38.8 million tonnes.

⁶ Tariff Council regulation on monopolistic entities (including the areas mentioned in the report) is carried out in accordance with the "Rules for Ensuring State Supervision over the Formation and Application of Tariffs Subject to State Regulation" approved by the Cabinet of Ministers Resolution No. 247, dated 30 December 2005. Prices of oil products (excluding petrol, diesel and bitumen) are no longer regulated by the state. This is in accordance with Resolution No. 1 of the Cabinet of Ministers of Azerbaijan, dated 4 January 2021, on "Amendments to the "List of Goods (Works, Services) whose Prices (Tariffs) are Subject to State Regulation" approved by Cabinet of Ministers Resolution No. 178, dated 28 September 2005.

⁷ As of 1 August 2020, the retail price of natural gas for households has been fully liberalised. However, the government of Ukraine has capped the gas price for households at UAH 6.99 per 1 cubic metre (including VAT and transportation fees) over the period of the quarantine due to the COVID-19 pandemic.



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