



# SYSTEMIC REPORT

## **NATURAL MONOPOLIES vs. COMPETITIVE BUSINESS:**

how to improve relations

January 2016

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## ACKNOWLEDGEMENTS

This report has been prepared by Deputy Business Ombudsman Tetyana Korotka under the supervision of Business Ombudsman Algirdas Šemeta, in cooperation with the American Chamber of Commerce, the European Business Association, the Federation of Employers of Ukraine, the Ukrainian League of Industrialists & Entrepreneurs, and the Ukrainian Chamber of Commerce and Industry.

We would like to express our thanks to Serhiy Makarenko (Pepsico), Andriy Chyrva (Mondelez International), Olha Adamovska (ENI Ukraine), Oleh Palaida (Sety i Systemy), Olena Stepanova (AmCham), Ruslan Tormosov (Municipal Development Institute), Olena

Nych (Municipal Development Institute), Ima Khrenova-Shymkina (GIZ UA), Viktoria Hryb (DTEK), Ruslan Kalnytskiy (Prudens) and Fedor Luchenko (Ukrniikomunproekt) for their most useful comments, suggestions and engagement throughout the investigation process underlying this report.

Assistance provided by experts from the National Energy and Utility Regulatory Commission, the Ministry of Economic Development and Trade, and the Antimonopoly Committee is greatly appreciated.

This report could not have been accomplished without the support of the BOC investigators team.

## LIST OF ABBREVIATIONS

<b>BOC</b>	Business Ombudsman Council
<b>LEB</b>	Local Executive Body
<b>EU</b>	European Union
<b>MinReg</b>	Ministry of Regional Development, Construction and Utilities
<b>NEURC</b>	National Energy and Utility Regulatory Commission
<b>RAB</b>	Regulatory Asset Base
<b>VRU</b>	Verkhovna Rada of Ukraine (Ukraine's legislature)
<b>CMU</b>	The Cabinet of Ministers of Ukraine, the Government of Ukraine
<b>NERC</b>	National Electricity Regulatory Commission

## INTRODUCTION

The Business Ombudsman Council regularly receives complaints about the way that natural monopolies<sup>1</sup> operate in Ukraine in supplying power, water, natural gas and heating.

For domestic customers of natural monopolies, the cost of such goods and services could reach over 30-70% of production costs. The fact that natural monopolies are able to inflate prices for their services removes any incentive for them to reduce processing, generation or distribution costs by upgrading assets, introducing new technologies, or streamlining, and leaves non-essential expenses in the cost of services. This leads to inefficiency and increased depreciation of the networks that provide services. This deterioration is the main cause behind accidents and failures, and poor quality services, resulting in higher risks for business customers and higher production costs all around.

Improving relations between customers<sup>2</sup> and natural monopolies is also among the commitments that Ukraine took on in the context of the Association Agreement with the

EU and the conditions under which Ukraine joined the Energy Community Founding Agreement and the Third Energy Package<sup>3</sup>.

This means that ensuring a balance between the public interest, including the interests of customers, and the interests of natural monopolies is an important task for the Government of Ukraine. Thus, proper infrastructure regulation should include:

- economically justified rates (price regulation);
- non-discriminatory access to the services of natural monopolies (access regulation);
- an appropriate minimum level of quality and safety in such services (technical regulation or quality control).

However, currently Ukraine's regulation is still not effective in some spheres where natural monopolies operate. At a BOC Supervisory Board meeting on October 29, 2015, it was decided to develop the systemic recommendations on this subject.

<sup>1</sup> A natural monopoly is a monopoly in an industry in which it is most efficient, that is, involving the lowest long-run average cost, for production to be permanently concentrated in a single firm rather than contested competitively. Because it is economically rational to have certain natural monopolies, governments generally regulate such operations to ensure that consumers get a fair deal. Utilities are a good example of a natural monopoly. In Ukraine, most natural monopolies are currently in private hands.

<sup>2</sup> In this report "customers" only means business representatives

<sup>3</sup> The Third Energy Package consists of five documents: 1. Directive 2009/72/EC concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC; 2. Directive 2009/73/EC concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC; 3. Regulation (EC) #714/2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) #1228/2003; 4. Regulation (EC) #715/2009 on conditions for access to natural gas transmission networks and repealing Regulation (EC) #1775/2005; 5. Regulation (EC) #713/2009 of the European Parliament and of the Council of July 13, 2009, establishing an Agency for the Cooperation of Energy Regulators.

## 1 BACKGROUND INFORMATION

### 1.1 Objectives and structure

The purpose of this report is to provide recommendations directly aimed at removing problems in the provision of utility services

through cooperation between natural monopolies and business, and to propose some practical, long-term solutions to the Government of Ukraine.

### 1.2 Methodology

The analytical part of this report is based on complaints received by BOC and illustrated in the Annex 1, propositions from business managers, discussions with leading local and international expert organizations, a review of relevant literature, and the BOC's own conclusions. The Council has also used information publicly available on the web sites of certain public entities.

Having carefully studied complaints it had received, the BOC decided to narrow the topic to the four key issues regarding natural monopolies and complementary markets<sup>4</sup>:

- electricity (power generation, supply, distribution, and transmission);
- centralized water and sewage;
- centralized heating (generation, supply, and distribution);
- natural gas and oil (supply, transportation and distribution).

<sup>4</sup> As defined in Art. 6 of the Law of Ukraine "On Natural Monopolies."

## 2 PROBLEMS RELATED TO ENGINEERING NETWORKS ACCESS

### The Problem:

Equal, non-discriminatory access to the networks or infrastructure of natural monopolies is problematic for commercial entities in Ukraine. This applies both to hooking up to networks and access to the services provided by such natural monopolies. Such problems add to business risks in a variety of ways.

- Potential customers, that is, companies that need access to the infrastructure, do not have enough information to evaluate the financial and time costs for such a connection. This unpredictability requires additional financial and time resources in business planning.
- According to current rules, the process of hooking up new customers to network and infrastructure development are arbitrarily differentiated for various types of infrastructure.
- Operators have different approaches to determining the cost of new hook-ups. Private businesses are unhappy with a situation where they not only finance new hook-ups but also pay for infrastructure owned by monopoly operators to be improved<sup>5</sup>.

Anti-monopoly legislation calls for specific mechanisms to end the abuse of monopoly positions. However, international practice has shown that a modern regulatory framework is more effective than enforcement at preventing such violations.

Today, customers are funding the design and construction to join a monopoly's network. Yet it is often the monopoly itself that, instead of ensuring development and access, slows down the process by establishing unfair rules that

discourage investors and force them to build new production facilities in other jurisdictions.

The main problems with accessing infrastructure and networks include:

- complicated, opaque procedures for customers to be hooked up to network, providing opportunities for corruption and increasing customer costs, as well as unjustified refusals to provide services;
- the addition of works and equipment to Technical Specifications that are not directly related to a particular hook-up; the installation of equipment of a certain class, brand or trademark; and excessive labor costs to prepare Technical Specifications;
- the absence of clear timeframes for the work involved in connecting a customer to the network, which delays the completion of work and adds to the customer's costs unjustifiably.

In addition to being a form of abuse of their monopolist position on the part of utility providers, such problems are often also tied to a lack of capacity to handle certain connections. This, in turn, is connected to the lack of territorial development plans, opaque decision-making processes in local government offices, and an overall lack of coordination among the parties to this process due to legislation that is not integrated.

A more in-depth analysis of the problems associated with hooking up business facilities to utility networks would make it possible to both identify common problems for all kinds of infrastructure and to propose ways of resolving them in each separate sphere.

<sup>5</sup> Currently, the companies that provide heat, power and gas are mostly private corporations, while the providers of water and supplementary services such as building maintenance, and are community enterprises.

## 2.1. Access to information necessary for businesses to plan hook-ups

Missing and unreliable information about actual capacities, illustrations of planning restrictions, and networks of main streets, information about networks and data contained in the urban planning cadaster, and environmental and geotechnical conditions encourage continuing abuse and unjustified demands for additional materials to prepare terms of reference for connecting to the network.

It should be noted that the systemic lack of coordination of all parties involved in hooking up a facility is partly a reflection of incoherent legislation. One way [to improve the situation](#) would be to increase the visibility of each phase, such as:

- (1) The MinReg should develop amendments to the Law of Ukraine “On amending the Law of Ukraine ‘On regulating urban development activities’” to encourage local governments to develop master plans and detailed plans for their territories;
- (2) NEURC should require network operators to publish information about the technological requirements for hook-ups and warehouse facilities to facilitate the implementation of investment programs;
- (3) NEURC should require licensees to disclose all consumer applications to hook up and their status.

## 2.2. Share contributions to local infrastructure development

Art. 40 of the Law “On urban development activity” states that the developer of a commercial property must make a cash payment to the local executive body via the local budget towards the development of infrastructure in that community. Moreover, the law prohibits making such payment in kind, that is, with property or works. It also contains an exhaustive list of exemptions from this payment and stipulates the cap on such contributions at 10% of the estimated cost of constructing a non-residential building and 4% of the estimated cost of erecting a residential building.

### Problematic issues include:

- Sec. 8 of this Law, which states that the contribution shall be set individually for every developer at between 0% and the cap established for that category of developer;
- the high share of the contribution, which can be as much as 10% of the overall value of an industrial facility;

- the only mechanism to challenge the size of a contribution being through the court system or “informal negotiations” with local government officials.

Moreover, the developer is expected to pay this contribution in full before the facility begins to operate. At the same time, the developer is expected to participate in the construction of the necessary extensions to various utility networks because the existing infrastructure is inadequate.

The very nature of this contribution, regardless of its size, appears to be an additional hidden tax, although it is not directly linked to any measures to enable the functioning of the facility while increasing the cost of construction and of access to various networks. This opinion is confirmed by the very fact that this payment is not on the list of local taxes and fees as established in Ukraine's Tax Code. Nor is the corrupt nature of this payment in any way diminished by a statement in the Law that “in cases where the developer is obligated to

extend the network beyond its building site, the share contribution shall be reduced by the cost of laying this section.”<sup>6</sup>

According to some business experts, the share contribution, which is intended to develop infrastructure in the region where the property is being developed, has not only done anything like this in the years that it has been in effect, but has also been a serious obstacle to the development of business and commercial and industrial infrastructure development projects in urban areas that generate new jobs.

In order to establish clear and transparent rules in this area, the BOC recommends:

- To MinReg: to develop amendments to the Law “On regulating urban development activities” dropping the developer share contribution as an outdated mechanism that is applied in a non-transparent fashion and appears to be an indirect tax, which is forbidden by law;
- To the Ministry of Regional Development, Construction and Residential services: to organize public hearings with business associations, experts and the community to come up with better instruments for territorial development on a transparent basis.

## 2.3. Access to power grids

BOC recommendations regarding access to power grids were represented in our Systemic Report of July 2015. In addition to issues that were substantively discussed in our Systemic Report “Getting Access to Electricity”<sup>7</sup> and the solutions we then recommended, in the current report we would like to discuss some financial aspects associated with access to power grids.

Currently, financial issues related to access to power generating equipment are regulated by National Energy Regulatory Commission (now NEURC) Resolution “On approving the Order to finance services for access to the power grid” №1467 dated November 21, 2013, and calculated based on special methodology approved by NEURC Resolution №115 dated February 12, 2013.

The current payment algorithm includes a fee for getting access plus reimbursable financial assistance provided by the consumer to the power company. In practice, this amount often comes to more than 100% of the cost of the

provided services.

Moreover, the current approach to calculating the cost of access to power generating equipment for a non-standard connection does not allow customers to calculate the approximate cost of access and plan accordingly. The mechanism for financing costs provided in current legislation by offering customers reimbursable financial assistance is too unspecific, opaque and actually a financial burden for customers. As we mentioned in our Systemic Report of July 2015, the BOC generally supports the approach now being used in this professional environment, which is based on a fixed hook-up fee of 1 MW of power at the rated capacity.

The arguments offered by the NEURC, licensees, businesses and the BOC in favor of such a decision, along with its benefits were presented in detail in the BOC Systemic Report “Accessing the Power Grid.”

<sup>6</sup> Overall, Ukraine is currently 83rd of a total of 189 countries for ease of doing business, but for the indicator “Getting construction permits,” it is actually 140th, because of the extra financial burdens on developers.

<sup>7</sup> <https://boi.org.ua/en/publications/reports/3-report-on-systemic-problem-getting-access-to-elect>



## International Practice

There are two main approaches to pay for technical hook-ups. In the United States, there is a standard fee per kW of power, and there is no differentiation between “standard” and “non-standard” connections. In Europe, some countries also do not have a separate connection fee and the cost of constructing new sections of the power systems is included in the electricity rate. The governments of those countries originally motivated distribution companies to provide reserve capacity so as not to hinder the development of SMEs.

Interestingly, the share of distribution in consumer rates in Ukraine is only 5.6%, whereas in Germany it is over 35%. Precisely because of this, power companies have the means to provide high-quality power supplies, not only for existing customers, but also to allow a reasonable margin for start-ups.

Practically, this proposal requires amendments to various laws that regulate different stages of accessing power grids, including the Law “On the power industry,” “On the basis for Ukraine’s power market to function,” “On the regulation of urban development,” “On natural monopolies,” and other legislation. This includes a series of measures that should be implemented as part of a comprehensive reform strategy in this sphere, in particular [BOC recommends](#) to the Ministry of Regional Development, Construction and Utilities and the National Energy and Utility Regulatory Commission:

- (1) to develop a concept of switching to a fixed hook-up rate with due consideration of all required procedures, financial sources and stakeholders that relieves the customer from the obligation to seek Technical Specifications for getting hooked up;
- (2) to take into account all possible sources of funding (for modernization) in order to establish fair value of hooking up;
- (3) to develop clear parameters of hooking up calculation. For example, these basic parameters could include:
  - power in kilowatts declared by customer and distance in meters from the access point to the existing network;

- reconstruction fee for the necessary reconstruction of the existing network with the purpose to increase their capacity, which in turn requires technical information from regulators and operator;
- the need for reconstruction and development of the network with regard to the forecasts for the accession of new consumers;
- construction payment for the physical connection of the power grid and customer.

In the short term, the NEURC should:

- (1) hold additional public hearings in the process of preparing a Bill “On amending certain legislation regarding the fees for being connected...” to consider issues that arise when customer facilities are being hooked up to power grids and to discuss in detail possible ways to regulate them through legislation, including issues of greater access to information about the condition of the network, available capacities, an open register of hook-ups, and so on;
- (2) improve monitoring of compliance with license conditions in terms of maintaining proper conditions for providing electricity, which will prevent violations in the power supply industry.

## 2.4. Access to central heating networks

The procedures for connecting to centralized heating systems are regulated by the Law “On heating supply,” “On regulating utilities and residential services,” “On electricity,” legislation on alternative energy, and NEURC Resolution №343 “On approving the rules for connecting to centralized heating systems” dated October 19, 2012. The issue of connecting to heating systems needs to be considered in two aspects:

- connecting business facilities that need to be ensured heating for internal use to heating networks;
- connecting market entities that intend to operate heat generation facilities to heating networks.

### **Connecting business facilities that need to be ensured heating for internal use to heating networks**

In general, hooking up such facilities to centralized heating systems follows the same standard logic but it has some special features as well. Today, most of the heat-generating companies are actually competing for customers because of the widespread trend towards individual heating systems among both commercial and residential users, which means that they disconnect from the centralized networks.

For this reason, the application for a connection to the heating system, filling in information in the application form, and the issuing of Technical Specifications for being hooked up are all regulated procedures. For instance, the Technical Specifications are issued in the course of 20 days, and the cost for issuing such Technical Specifications is based on the number of working days it takes engineering specialists to prepare them. The cost ranges between UAH 600 and UAH 1,000: in Vinnytsia it costs UAH 600, in Poltava it's UAH 600, and in Komsomolsk it's UAH 800.

There are, of course, occasional instances when the monopolies abuse their position and set additional requirements for these Technical Specifications. For instance, just in the process of writing this report and studying some utility

websites, the authors of this report noticed some additional requirements such as inserting urban development conditions and restricting how a piece of land might be developed. This should be subject to an investigation by the Anti-Monopoly Committee.

How the customer or a customer's contractor is supposed to prepare project documents to connect a facility to the heating network and agreeing the details with the utility company is established in construction regulations. Estimates of the value of design and construction work are calculated using software approved by the Ministry of Economic Development and Trade.

The provider then arranges the connection to the heating network on the basis of a contract signed between the owner and the customer. The terms and conditions must be in line with those in the Standard Contract for connecting to the heating network. The fee for hooking up newly constructed, reconstructed, or upgraded heat-using facilities to a centralized heating network is based on the value of the works as established in the hook-up documentation as a ratio between the requested capacity and available capacity.

### Connecting market players that intend to engage in heat generation

Hooking up heat-generating organizations to existing heating networks is a separate problem, connected to doing business in Ukraine and directly to market access for new participants. According to law, the owner of a heat generating company is supposed to apply to the monopoly that runs the network and the heat generation for Technical Specifications for hooking up to the heating network. Incidentally, this is completely in line with the terms of the Second and Third Energy Packages, which deal with the distribution of the heat production, distribution and sales functions, and the level of access to heating supply networks.

The Law “On heating supply” states that commercial entities that distribute heating must connect a heat-generating entity that intends to produce heat once it has met the technical requirements and signed a contract to be connected to the network. What’s more, heating supply companies that are delivering heat using their own heating networks must ensure equal access to their networks for all commercial entities on a contractual basis.

However, the law states that if two or more heat-generating entities are hooked up to the trunk or heating network of a heat-generating company, the priority in signing contracts to buy heat from the company shall be established on a competitive basis. A tender shall be organized by local executive bodies in accordance with the procedure provided by law. Notably, how such tenders are supposed to be organized is not written into law at this time, and there are no regulations that grant local government bodies the authority to establish such a procedure.

The fee for hooking up to a heat-generating facility to a heating network shall be established in the terms and conditions of a contract.

To summarize this section and to prevent abuse on the part of monopolies in terms of access to heating networks, [the BOC recommends](#):

- to improve the monitoring of compliance with license terms in supplying, operating commercially in generating heat, distributing heat over trunk and local (branch) heating networks, supplying heat and power, including by having the NEURC to approve the Procedure for monitoring compliance with License Terms by licensees;
- to NEURC: to regularly analyze customer complaints about service, especially the issue of hooking up to a heating network, and using the results as the basis for disciplining guilty parties;
- to NEURC and the Anti-Monopoly Committee: to undertake ongoing information and awareness work with licensees with the purpose of removing abuses of monopolist position that have been uncovered;
- to Anti-Monopoly Committee: to ensure that the situation is analyzed on a regular basis and that licensees are fulfilling their duties;
- to MinReg: to prepare a regulatory base to resolve issues with the authority of local government agencies and the procedure for determining the priority of contracts for the purchase of thermal energy should two or more heating supply companies be connected to the heating network;
- to NEURC, MinReg, and the Anti-Monopoly Committee: to hold consultations with licensees, experts and the public on issues around accession for producers and consumers to heating networks and ways to resolve them.

## 2.5. Connecting to water supply and sewage systems

Centralized water supply and sewage services are provided in accordance with Art. 5 of the Law “On natural monopolies,” as they also belong to that sphere.

Currently there is a range of legal acts that regulate the legal aspects of hooking up to water supply and sewage systems. Specifically, the section “Connecting facilities to the centralized water supply and sewage system” is included in the rules for using centralized community water supply and sewage systems in the cities of Ukraine; approved by MinReg Order №190 dated June 27, 2008. However, the scope of these rules is limited to only a few technical procedures and does not cover the entire range of technical and financial issues associated with connecting to water supply systems.

Most problems with abuses regarding hooking up companies to the water management system are related to the process of getting and meeting Technical Specifications.

From an engineering point of view, the need to get and meet Technical Specifications is based on several points. When a new facility, that is, a facility that was not provided with water and sewage previously, is hooked up to the centralized system, the water company takes upon itself the responsibility to make sure this is done properly. To fulfill this commitment, the water company designates in the Technical Specifications where the new customer should be connected to the centralized water supply and sewage system, the diameter of the pipes to be used, and the mandatory features of water metering junctions. It can also require the pumping station and reservoir to build additional capacity. All these issues are laid out in the section “Connecting facilities to centralized water supply and sewage systems” contained in the rules for using centralized public water supply and sewage systems in Ukraine’s municipalities that were approved by Ministerial Order №190, dated June 27, 2008.

When drawing up the Technical Specifications, the water company requests that the new customer fill in an application form that includes the technical features of the facility being planned, its scope, and the type of water supply and sewage required. The preparation of Technical Specifications is a paid service and its price is approved by the NEURC based on the labor involved. In fact, these human resource costs are limited by the value of the time spent by a single engineer from the technical department. Problematic issues in this area include:

- the requirement to get a new set of Technical Specifications when the owner of the facility has changed, even without any technical reasons for this, such as significant changes in the scope and type of consumption. This requirement is ripe for abuse, while the text of the rules mentioned above clearly means that “hooking up the facility to the network” refers to the physical connection, not to the signing of a contract with a new customer;
- Technical Specifications that too-often include the requirement to build additional capacity at the pumping station and/or reservoir not at the site itself, but in the centralized network with redundant features;
- the requirement to hand over certain assets to the water company, such as pipes, pumps and so on. Typically, these requirements can be found in Point 9 of the Technical Specifications, “Special conditions.” The water company’s reason for this is to legalize the source of goods and material assets by placing them in inventory so that it can later write them off for planned renovation work. This kind of set-up is clearly abusive and is often the source of corruption on the part of water company employees;
- Technical Specifications that require a particular type of water meter be installed or describe the basic features of this or

other measuring device to be installed, but name specific brands and models of instrumentation. This kind of requirement is justified as “the best of intentions to ensure the most precise modern instruments with the longest rated period of trouble-free use.” However, this is, once again, an abuse of monopolist position: the customer should have the right to install any device from the approved State Consumer Standards Committee list that meets the requirements for type and diameter in engineering specs;

- forcing customers to make use of another paid service, in addition to the Technical Specifications: preparing documents that are required in order for the Technical Specifications to be issued, such as a

contingency plan. Any documents prepared by a customer in-house are returned as “not properly formulated.”

- existing legislation contains gaps in terms of establishing clear responsibility among CEBs for the development of procedures for access to water supply systems that would ensure a unified approach to resolving access to the water supply and sewage systems, getting Technical Specifications, and paying for being hooked up to these systems. The BOC considers that the NEURC should be responsible for establishing rules addressing the issues presented above in accordance with Art. 6 of the Law “On the regulation of utility services.”

## BOC Recommendations

The BOC recommends the NEURC to renew the rules for connecting to water supply and sewage systems so that they regulate, among others, the issue of providing/receiving Technical Specifications, the fees for connecting to the water supply and sewage network based on a formula using the value of the works and services needed at various stages in this process.

The new rules should clearly define “access” and “connection/hook-up” as well as contain norms that regulate a number of issues related to:

- issuing and receiving permission to connect;
- drawing up construction blueprints showing the water and sewage connections;
- providing and receiving Technical Specifications, which includes establishing the order or methodology for formulating the value of specification issuing services;

- establishing the procedure for paying for a hook-up that includes the value of works and services at various stages of this process, including works and services related to hooking up to water supply and sewage networks;
- determining the share contribution, with the express intention of preventing cases where customers are pressured under the guise of a share contribution to buy materials and/or to carry out certain works on behalf of the provider that are not directly related to the procedure of hooking up ordered by the customer;
- covering temporary connections;
- launching networks for further transporting of water resources;
- changing ownership to prevent abuse and setting excessive installation requirements.

## 2.6. Access to gas distribution systems

Ukraine has committed itself to implement EU directives in accordance with the Association Agreement and the Protocol of Accession to the European Energy Community Founding Agreement. The Third Energy Package requires that the functions of operator, gas distribution company and gas supply company are to be separated, the principles of open competition instituted on “potentially competitive” markets, and the rights of consumers and the safety of natural gas deliveries ensured.

Ukraine recently took a significant step forward in establishing a properly working, competitive market for natural gas that satisfies the main legal requirements of the European Union, including common rules for domestic natural gas markets and the conditions for access to gas distribution networks.

Four procedures for gaining access to the gas distribution network were recently added to NEURC regulations and they have received positive feedback from business:

- № 2493 “On approving the Gas Transit System Code;”
- № 2494 “On approving the Gas Distribution System Code;”
- № 2496 “On approving the Rules for the Supply of Natural Gas;”
- № 2517 “On approving the methods for calculating and establishing rates for the transport of natural gas at entry and exit points, based on multi-year regulation.”

The new procedures for being hooked up to the gas distribution network have significantly simplified access to the networks. The legal innovations that implement Ukraine’s commitments before the European Union also resolve the issue of access to gas distribution networks for:

- businesses that require natural gas for their internal needs;
- market players who intend themselves to operate as gas distributors.

### Connecting business facilities that need natural gas for internal use

Today, a modern approach is being used that requires the gas distributing company to take responsibility for the work involved in hooking up a facility that will use gas to the gas networks: surveying, design, building and installation, and providing comprehensive support for the entire process:

- **Standard Connections:** The customer only needs to sign a contract with the gas company for standard connection services.
- **Non-Standard Connections:** The gas company is responsible for building and commissioning outside gas networks from the point where the capacity is provided to the hook-up point; installing a meter at the hook-up point for commercial payments that is shielded against weather and unlawful

access; and physically connecting the external and internal gas pipes at the hook-up point.

The customer is supposed to take care of drafting the design estimates for outside gas supplies, its approval and submission to the gas distribution company, the blueprints for internal distribution from the hook-up point to the customer’s own gas equipment, their approval by the gas company, and ensuring that the internal gas network is properly built and commissioned.

There is one unresolved controversial issue related to the value of hook-up services. Right now, the value of these services is defined by NEURC Resolution №77 “On approving the Procedure for calculating payments for



connecting customer facilities to gas networks” dated January 31, 2013. The NEURC sets the hook-up fee individually for every oblast, based on the category and location of the consumer’s facility. Fees for non-standard connections are determined on the basis of the design estimates for external supply and are based on the Technical Specifications for external supplies.

However, complaints from business have mentioned not only the significant rise in this fee, but also the major gap between the sizes of the fee in different oblasts.

#### BOC recommendations

- (1) The NEURC should analyze the state of play and, if need be, make the necessary adjustments to the way that the fee for connecting customer’s facilities to gas networks is calculated based on the principle of a fair price for connecting customers to gas networks.
- (2) The Anti-Monopoly Committee should join this effort in order to determine what is a “fair price” for the services and prevent an abuse.

### **Connecting market players that intend to engage in supplying natural gas**

With the recent adoption of the Law “On the gas market,” it is expected that the market will encourage new gas suppliers who will be subject to licensing. The licensing conditions approved by NEURC Resolution №9 dated January 12, 2015 contain a requirement to agree the natural gas customer database with gas distribution companies, as prescribed by NEURC. Although this rule has been set, the procedure has not been developed yet, so new gas suppliers cannot yet enter the market.

#### BOC Recommendations:

The NEURC should adopt the procedure for agreeing the natural gas customer database with gas distribution companies as soon as possible.

### 3 TRANSPARENCY AND CLARITY IN RATE-SETTING

#### The Problem:

Businesses complain about untransparent rates of utility companies. The business community wants to have more and clearer information regarding the components of the rates they are asked to

pay. There is also a lack of information regarding upcoming rate increases. This leads to additional risks and uncertainties in the planning of commercial activities, corporate development, and so on.

#### 3.1 Regulating rates

Rates of natural monopolies are regulated by the Law "On prices and pricing" and other legal acts. Vital issue is rate setting methodology for each type of utilities. Currently "cost-plus" methodology is widely used in Ukraine. However, best international practice recommends using incentivized rate-setting using Regulatory Asset Base or RAB methodology.

The Association Agreement between Ukraine and the European Union and a range of other international treaties of Ukraine call for incentivized rate setting mechanism. The coalition agreement of the Verkhovna Rada of the VIII Convocation also calls for a switch to incentivized rates at a regulated level for utility services.

This means that the regulator and the country's natural monopolies will stop the old soviet practice of setting rates for electricity, heating, water and gas, and switch to a mechanism based on the valuation of capital assets and investments.

RAB methodology sets the value of the necessary income based on resource provision that is at an agreed level of reliability, quality customer service, and motivating suppliers to lower costs. This should encourage operators to invest in infrastructure and to set transparent rates.

#### International Practice

International practice illustrates this effect amply. Pioneer countries switched over more than 20 years ago. The UK saw the cost of power distribution companies and power transmission rates go down twice in 15 years. In Romania, asset depreciation rates decreased from 75% to 48% over 2004–2011.



At present, rates are set on the basis of cost-plus methodology in four areas: water supply and sewage, heating, power and natural gas. So far, the NEURC has developed incentive-based rate methodologies for centralized water supply and sewage, and for heating, enshrined in Resolutions №356 "On approving the rate-setting methodology for centralized water supply and sewage on the principles of incentive management" and №357 "On approving the rate-setting methodology for centralized heating through main and local heat distribution networks on the principles incentive management," both dated November 2, 2012.

Despite current incentive-based rate setting methodologies, the market experts say that they have not been applied in practice yet. The reasons for the failure to apply these methodologies reflect a number of problems that require these documents to be further revised:

- Current asset valuation methodology does not cover the technological aspects of utility facilities.
- No full-scale program on loss accounting is being implemented among networks.
- Benchmarking and operational cost calculation have only recently been started.

As for the supply of power and natural gas, such incentive-based rate setting methodologies have not been even developed at all. Ukraine is now preparing to switch from cost-plus to incentive-based rate setting in the power industry. Six regional power generation and distribution companies, called oblenegos, are piloting it. It has also been reported in the press that incentive-based rate-setting methodology will be used by regional natural gas distribution companies, called oblgas.

The NEURC plans to implement incentive-based rate setting for all power generation companies by 2020. At present, the Commission has begun arranging for this transition and approved several necessary technical rulings.

## 3.2 Using RAB methodology

RAB methodology is now considered to be the best practice in the world. However, like any international best practice, its application in Ukraine requires some adaptation, for instance, in identifying key performance indicators of the value of assets, or determining the rate of return

on invested capital that will be applied to the base assets calculation. This question has not been fully answered by the regulator and market players. The NEURC plans to use a 5% rate for initially invested capital and 15% for the new capital investments.

## International Practice

Country	Return on initially invested capital	Return on initially invested capital
Greece	11.0%	11.0%
Poland	9.0%	9.0%
Czech Republic	7.9%	7.9%
France	7.3%	7.3%
Slovakia	6.0%	6.0%
Ukraine (planned)	5.0%	14.8%

Source: Press materials and the E&Y Report "Mapping power and utilities regulation in Europe 2013"

The NEURC, with the help of international technical assistance projects, is currently in the process of developing a concept for switching all utility market rate setting to RAB methodology that will be focused on proper preparation of the sector for reform.

A significant number of indicators that will be used for further rate calculations need to be developed and approved by the NEURC. The input data for these indicators will be based on statistical data for benchmarking. However, the Commission has just begun this work, so available information is not illustrative for further calculations yet. Operators need to provide evaluations of their assets as a first step for further rate setting, but not all operators are ready to do this at their own cost.

In the current economic conditions, with rising rates for electricity, heat, gas, and water and sewage services, it is essential to ensure transparency in the establishment and application of new rates. Moreover, this should be provided regardless the methodology used to calculate the rates. There are great expectations for increased transparency with the recent adoption of the Law "On the specifics

of access to information in power and natural gas supply, centralized hot water, centralized drinking water and sewage services." This law will help to implement the provisions of EU Directive 2006/32 on providing more information to end-users on energy efficiency, such as:

- prices/rates and their components for all categories of customers; changes in prices/rates; share and cost of electricity produced by generation capacity according to different types of generation;
- comparison of prices/rates for goods, works and services in different regions of Ukraine, as well as comparison between Ukraine and other countries;
- projections of price/rate fluctuations and the reasons for such changes;
- trends in historical cost components of prices/rates;
- qualitative evaluations of goods, works or services;
- descriptions of investment programs and sources of financing, etc.

## BOC Recommendations

- (1) The NEURC needs to develop a plan for the switch from cost-plus rate setting to RAB methodology for power and gas companies and implement all the necessary measures to ensure incentive-based rate setting in centralized heating, water and sewage services;
- (2) The State Property Fund, together with the Ministry of Energy, the MinReg and the NEURC, needs to draft amendments to asset valuation methodology to improve the base for assessing and verifying results;
- (3) The NEURC needs to provide a training program for both its staff and licensees;
- (4) NEURC, the state regional administrations, and the local executive authorities shall ensure timely implementation of the Law "On the specifics of access to information in power and natural gas supply, centralized hot water, centralized drinking water and sewage services".

## 4 QUALITY AND SAFETY IN NATURAL MONOPOLY SERVICES

### The Problem:

Natural monopolies in Ukraine have not been modernizing or developing their infrastructure. Yet, maintaining quality infrastructure to uphold the supply and reliability of services is a key element to ensure the necessary level of production and perform to the satisfaction of stakeholders.

In gas and electricity, quality control and proper monitoring systems exist and are based on a set list of indicators, special reports, etc. However, such systems do not exist in centralized heating and water supply. Moreover, the NEURC has limitations on how it may apply penalties for poor quality services of licensees. The NEURC has at its disposal penalties and the right to suspend or even withdraw licenses. However, in

practice, these methods are ineffective because of the disproportionately low level of fines, while suspending licenses among monopolies can only lead to worse customer service.

On the other hand, to maintain the current level of services and to improve their quality, Ukraine's monopolies have to reinforce the accountability before the regulator, consumers and the general public.

International best practice shows that consumer access to quality information and their engagement in overseeing the services lead to more trust and better cooperation with suppliers. That leads to better quality services all around.

### BOC Recommendations

In the regulatory area, it is recommended that the NEURC:

- (1) Institutes methods to improve tracking systems in the networks;
- (2) Develops service quality indicators and classify them accordingly;
- (3) Develops quality control monitoring and enforcement systems;
- (4) Designs the procedure for overseeing that licensees uphold the terms of their licenses to do business in all areas of operation: power, water, heat and gas distribution;
- (5) Develops a mechanism for interlinking rate levels and quality of service;
- (6) Works on a systemic solution by amending legislation. The GOU drafted such amendments and submitted them to the Verkhovna Rada for approval as Bill №2966 "On the National Electricity and Utility Regulatory Commission"<sup>8</sup> dated May 28, 2015. This draft extends the powers of the regulator and strengthens sanctions against natural monopolies. Among

the main innovations in this Bill is increasing the powers of the regulator to establish and oversee work standards at utility companies, to set the requirements for quality and cost of services that are offered to consumers, and ensuring that consumer rights are upheld whenever there are violations on the part of natural monopolies. The Verkhovna Rada of Ukraine should adopt the abovementioned draft law.

In the information area and consumer access to information:

- (1) The NEURC: to set up a single information system for the sector and a benchmarking system.
- (2) The state regional administrations, the local executive authorities, the NEURC: to establish the requirement on service providers to present information about key indicators of their operations on their websites.
- (3) The NEURC, the Anti-monopoly Committee, licensees: to improve responsiveness to complaints from customers.

<sup>8</sup> This bill was included in the matrix of strategic and institutional reforms as part of the World Bank's Second Programmatic Development Policy Loan.

## Examples of Cases received by BOC

### Case 1.

The Complainant claimed to be suffering from multiple cases of the Complainee's malpractice (the Municipal Water Enterprise - Vodocanal) specifically:

- (i) The Complainant's water management passport expired in 2010. Since then the Complainee refused to approve water management passport of the Complainant. The Complainant stated that the Complainee's officers persistently suggested to the Complainant to contract services on the development and approval of the water management passport to a particular private company. However, the Complainant refused to cooperate with this company since the price of its services was significantly above the average prices for similar services. In addition, the Complainant pointed out that the core specialization of this company was provision of marketing services, which was not relevant to such specific technical services as preparation of water management passport. Each time the

Complainant submitted an adjusted version of the water management passport with the account of the Complainee's remarks, the Complainee's officers provided new remarks and corrections thereto. In this respect the BOC investigator identified that the Complainee's remarks to the water management passport were not detailed enough and, thus, unclear.

- (ii) the Complainee tried to force the Complainant to sign service contracts with related parties of the Complainee's officers. The Complainee was persistently persuading the Complainant to sign service contracts with companies allegedly related to the Complainee's officers for various technical consultancy works (such as calculations of individual limits for sewage waters, calculations of increases of water supply limits, etc.). However, given the availability of its own qualified staff, the Complainant refused to cooperate with such companies.

### The BOC's involvement

The BOC investigator identified that constant unsubstantiated refusals to approve the Complainant's water management passport, as well as forcing the Complainant to sign contracts with specifically designated service providers could qualify as anti-competitive practices of the local authorities and their subordinate companies in the meaning of Article 15 of the Law of Ukraine "On the Protection of Economic

Competition". In addition, such actions could also be qualified as abuse of power in the meaning of Article 364 of the Criminal Code of Ukraine and corrupt practices in the meaning of Article 368 of the Criminal Code of Ukraine.

Thus, the BOC submitted a request to the regional Territorial Department of the Antimonopoly Committee of Ukraine requesting to:

- (i) investigate the instances of malpractice by the Complainee, and
- (ii) if confirmed, undertake respective response measures prescribed by the Law of Ukraine "On the Protection of Economic Competition".

Later on the AMC Department informed the BOC that, based on the preliminary investigation of the information and documents provided,

it identified instances of breach by the Complainee of the Ukrainian anti-competitive regulations. Currently, the case on breach of the Ukrainian anti-competitive regulations is under investigation by the AMC Department. The investigation timelines are not limited by law. It also transferred the information regarding the Complainee's malpractice to the Main Department of the Ministry of Internal Affairs for their investigation.

## Case 2.

The Complainant claimed unsubstantiated refusal by the regional department of the company Energozbut to conclude agreement on electricity supply with the Complainant. The Complainee provided additional request

to provide Operating Certificate to electricity generating equipment and the Certificate on Conformity, issued by the State Inspection of Architecture and Construction that is not required by the legislation.

### The BOC's involvement

At the request of the BOC, the National Regulatory Commission of Energy and Utilities examined the justification of refusal and obliged Regional department of Energozbut to execute the abovementioned agreement.

Due to the facilitation of the BOC, the Complainant entered into the agreement on electricity supply and began its operations.

## Case 3.

The Complainant claimed allegedly unlawful conduct of the officials of the Municipal enterprise "Vodokanal". According to the complaint, the officials of the Complainee (by acting in an unlawful manner) removed the seal of the water counter in the premises owned by the Complainant and claimed UAH 8000 for the water consumed without proper counter. Following the allegedly illicit removal of water counter seal the aforementioned Vodokanal

officials cut off the water supply. The premises where the water supply was cut off are used by the Complainant's mother as an internet café.

The Complainant reported over the phone on November 12, 2015 that the matter had already been reported to the police and state prosecutors. However, these bodies did not take any steps towards investigating the matter. The BOC is still working on this matter.





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