

Regulatory reform

in the residential services sector

*A policy paper prepared under the
“Policy Development Program / Regulatory Reform
in the Communal Services Sector of Ukraine” project*



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In this policy paper, consultants from the International Centre for Policy Studies analyze the introduction of a new system to regulate Ukraine's residential services sector.

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PREFACE

During the last decade, Ukraine's infrastructure branch has been in a state of transformation. Since switching to market principles, the country has been actively restructuring and privatizing enterprises in the power, communication and residential services sectors. Among the goals of this reform process were to bring about the financial recovery of these companies, to reduce government spending to support these sectors, and to ensure uninterrupted delivery of essential services.

A key feature in reforming the residential services sector is the delegation of management and regulatory functions to local governments. A new management structure and a policy of involving private sector, as indicated in the reform program, establishes new requirements of the system for regulating natural monopolies in this sector.

This paper offers an analysis of the problems with the current system for regulating centralized water supply, heating and sewage, and the alternatives for reforming it. Good regulation aims at balancing the interests of service providers and service users. Indeed, it is a necessary pre-condition for successful private sector involvement. A reformed regulatory system should eventually help raise the efficiency of the entire sector and attract investment.

This paper was prepared under the "Policy Development Program / Regulatory Reform in the Communal Services Sector of Ukraine" project, a joint initiative of the State Residential Services Committee and the International Centre for Policy Studies (ICPS), implemented under the "Local Government and Public Service Reform Initiative" program with the financial support of the Open Society Institute (OSI).

Part of this report was used to prepare a Concept for State Regulation of Natural Monopolies in the Residential Services Sector that was called for by the Law "On a statewide program for reforming and developing the residential services sector for 2004–2010."

This policy paper consists of five sections:

1. Regulation of natural monopolies
2. Social policy
3. Financial policy
4. Rate policy
5. Consumer protection

This paper identifies key problems in this area and provides recommendations for further steps the Government can take to bring about qualitatively new transformations. The appendices describe the consultation process which accompanied the development of this paper, provide the results of these consultations, and list the participants.

OVERVIEW

Reforming the regulation of natural monopolies in the residential services sector is not possible without a number of other steps: (1) changing national and local policies on social security and interbudgetary relations; (2) identifying sources of financing for sector development; (3) establishing mechanisms for regulating rates; and (4) introducing the principles of civil society. Unless the Government tackles these other issues, regulatory reform will either be very limited in its effect or progress with great difficulty. For that reason, this paper includes the analysis of those problem areas that affect the introduction of a new regulatory system in the residential services sector.

The first section, **STATE REGULATION OF NATURAL MONOPOLIES**, identifies key problems of the current regulatory system. The power to regulate residential services has not been clearly divided between elected local governments and local state administrations, which are part of the executive branch. The local government bodies that directly fulfill a regulatory function cannot remove themselves from political influence, which makes it difficult to regulate effectively. This section identifies the objectives of regulating natural monopolies and the criteria for evaluating the effectiveness of a regulatory body and its decision-making process. Two approaches are proposed: one is to establish a national regulatory commission, while the other is to prevent conflicts of interest and more clearly identify regulatory functions within the existing system.

Section 2, **SOCIAL POLICY**, examines the universal nature of residential services: their uniform and highly standardized quality and broad accessibility. In order to provide residential services to low-income individuals, the Government resorts to cross-subsidizing or direct support for parts of the population in the form of privileges (discounted or free services) and cash subsidies. This section looks at the costs and benefits of different social policy options intended to protect low-income consumers. Finally, there are a number of recommendations for providing social protection during the reform process.

Section 3, **FINANCIAL POLICY**, looks at options for financing the modernization of the residential services sector, where a large portion of the equipment is either outdated or worn out. There are four approaches to financing a renewal of these assets: (1) capital investment from municipal budgets; (2) capital investment from the providers themselves; (3) outside investors; and (4) loans to providers. This section includes a brief review of government policy aimed at improving the technical state of residential service providers. Attracting private capital is one of the most obvious ways to increase efficiency in this sector. This section presents some of the most typical approaches to involving the private sector in operating residential services and methods for selecting the best option among them.

Section 4, **RATE POLICY**, examines current issues in rate-setting policy in the residential services sector. To this day, there is no system for effective rate regulation: the process of rate-setting is opaque and the way it is done has not been established by a regulatory body, the financial stability of providers is uncertain, and consumers are not properly protected. This section suggests some ways for bringing order to the system of regulating rates based on specific goals, principles and methods.

Since the primary residential services remain natural monopolies at this time, consumer protection is even more important. The last section, **CONSUMER PROTECTION**, looks at three main options for arranging this protection: (1) specialized departments under local governments; (2) independent organizations; and (3) community organizations. Different consumer protection institutions can even co-exist. This section provides a comparative analysis of these options, their costs and benefits, and some recommendations.

STATE REGULATION OF NATURAL MONOPOLIES

Ukraine does not have a coherent government policy for regulating natural monopolies in residential services. Existing legislation does not clearly list regulatory functions and those responsible for them. The Law “On natural monopolies” lacks a comprehensive list of the powers assigned to national commissions or local governments that have been partly entrusted with regulating. As a result, regulatory powers are scattered along the executive chain of command. This situation makes it difficult to carry out the measures in programs intended to reform and develop the residential services sector: involving the private sector, reviving unprofitable companies, and upgrading technology

The current state of regulatory reform

The residential services sector is being reformed in several stages, based on international experience in reforming public utilities: (1) restructuring enterprises; (2) incorporating; (3) introducing regulation; and (4) engaging the private sector (see TABLE 1).

Table 1. Stages of transforming public utilities

Restructuring	Putting companies under the management of local governments; spinning off secondary production facilities and non-core businesses; merging or splitting up companies by region.
Incorporation	Changing the organizational and legal form of enterprises into joint stock companies; introducing market principles in the sector and limiting direct government intervention in company activities.
Institutional transformations	Introducing a regulatory system for natural monopolies.
Engaging the private sector	Engaging the private sector in owning or operating assets.

Source: OSI/LGI (2001), “Navigation to the Market: Regulation and Competition in Local Utilities in Central and Eastern Europe”

Regulatory reform has ground to a halt

The first stage of reforms has largely been completed. Most state-owned water supply, heating and sewage companies have been handed over to communal ownership, while local governments finance, manage and set rates in the sector. The process of merging and breaking up companies by region continues and new companies have emerged that are owned by their communities. However, the next stages of reform—introducing market relations and reforming state regulatory policy—are going very slowly.

The reform of local governments and interbudgetary relations has a direct impact on the formation of a regulatory system for natural monopolies. Most regulatory powers were handed over to local state administrations and local governments. The main purpose of the State Residential Services Committee, an executive body, is to implement policy in this area.

Given the lack of a consolidated regulatory policy, large-scale private sector involvement in owning and managing residential services assets has been put off

(see TABLE 2), while regional initiatives are running into interference. As a result, the financial standing of service providers and the quality of their services have been deteriorating.

Large-scale private sector involvement in asset management has been put off

Table 2. Organizational and legal forms of service providers in 2002

	State	Communal	Leased	Joint stock	Other
Central heating	–	273	22	15	4
Water supply and sewage	5	216	14	–	3

Source: State Residential Services Committee

Problems with regulating natural monopolies: competing functions

There has been no proper division of powers among bodies that:

- manage assets in the residential services sector;
- develop and carry out government and regional policy;
- regulate natural monopolies.

Thus, local governments combine the functions of: (1) a property owner, (2) an asset manager, and (3) a regulator. Combining the first two functions in a regulatory body leads to a conflict of interests when implementing regulatory policy. The local government tries at the same time to protect consumers and to maximize the corporate interests of the companies it owns. It is not always possible to maintain the necessary balance under these conditions.

Once water supply and sewage departments and central heating departments were changed into independent companies and handed over into community ownership, the problem arose as to how state administrations and local governments would be able to work together, especially in regulating rates. According to the Law “On local state administrations,” these local administrations are authorized to regulate the rates for various services, to determine and establish consumption norms, and to ensure that these norms are adhered to.¹ The Law “On local government in Ukraine” entrusts the executive bodies of village, township and city radas with authority to set rates—within the limits set by law—for personal, residential, transit, and other services provided by companies that are owned by the local community.²

Regulatory functions are not clearly divided between central and local governments

The State Residential Services Committee has also not clearly divided regulatory powers between local state administrations and the central executive body,³ although the Committee’s own functions in regulating rates are more clearly set

¹ See also the 25 December 1996 Cabinet Resolution “On establishing the authority of state administrations and the executive bodies of local governments (radas) in regulating prices (rates).”

² Elected bodies also have the right to agree these issues with companies, facilities and organizations that are not owned by the community following established procedure, and to ensure that the established prices and rates are adhered to according to the law.

³ The 19 August 2002 Presidential Decree “On the provision for a State Residential Services Committee” entrusts the Committee with regulating natural monopolies in the residential services sector.

out: it is within the competence of this Committee to establish a rate-setting procedure. Other regulatory functions belonging to central and regional bodies, specifically in regulating service quality, have not been so clearly divided.

The messy division of regulatory powers, lack of a consolidated policy, poor coordination among relevant ministries and departments—such as the Anti-Monopoly Committee, the National Electricity Regulatory Commission, the Ministry of Fuel and Energy, and the State Residential Services Committee—also reduce the effectiveness of government policy in this area.

Prerequisites for a new regulatory system

Reform of local government and interbudgetary relations has not been completed

Two things get in the way of actively developing and instituting a new regulatory system in the sector:

- incomplete reforms of local governments and interbudgetary relations. The rules dividing management and financial powers and duties between central and local executive bodies were never clearly established. The inevitable mismatch between powers and resources leads to certain bodies being unable to fulfill their duties;
- the politicization of a sector that provides key community services. In most regions, the government continues to avoid transformations that might cause any social shocks such as rate increases or withdrawal of services.

Two factors have spurred more active policy-making in the residential services sector lately:

- continuing financial losses in the sector;⁴
- growing dissatisfaction among the public with the quality of the services. This has spurred local state administrations to start acting decisively and farsightedly in reforming the sector.

As regional initiatives to reform the sector expand and the private sector is actively engaged, there is a need to introduce unified, nationwide principles and tools for regulating the residential services sector.

When rate-setting, licensing and standardization are inconsistent, it becomes impossible to increase the effectiveness of regional policies while reflecting objective differences. The lack of a coherent system creates a huge risk that transformations will be chaotic, which could prove counterproductive in the long run.

Private sector involvement may not live up to expectations

Private sector involvement, which has already begun, might not live up to expectations. As a rule, institutional transformations should precede private sector involvement, as they lower the risks of unjustified state interventions in the activities of private companies. Executive bodies that act in a regulatory capacity directly depend on political winds. This leads to populist regulatory decisions and a failure to consider corporate interests and long-term goals. There still are no effective procedures for appeal or mechanisms for both commercial and residential customers to file complaints against the unlawful actions of regulatory bodies. Nor are there any mechanisms for public oversight of natural monopolies by consumer associations. In other words, the regulatory system must be reformed as soon as possible.

⁴ For the first time, the 27 November 2003 Law “On the 2004 State Budget of Ukraine” allocated Budget subsidies to local budgets to take measures to prevent accidents and man-made catastrophes.

How to regulate natural monopolies

The goal of state regulation

The purpose of having the state regulating natural monopolies is to ensure proper market operation based on balancing the interests of the community, natural monopolies and their customers:⁵

The goal of regulation is to balance the interests of the community providers and users

- **TO INCREASE SOCIAL WELL-BEING BY ENSURING EFFICIENT OPERATION IN MARKETS DOMINATED BY A NATURAL MONOPOLY.** The objective of the regulator is to support the production and provision of residential services for the least cost. A typical feature of natural monopolies is declining average costs: high initial costs to establish their services are combined with fixed or even shrinking costs to serve each additional customer. For that reason it is desirable that there be one single provider that is a natural monopoly, as this ensures greater efficiency than competition would. Similarly, having competing companies on a single market of this nature leads to growing average costs to provide the services. An economically sound alternative to competition on a market that suits a natural monopoly would be to introduce competition for market entry.
- **TO ENSURE A FAIR RATE OF RETURN FOR NATURAL MONOPOLIES.** Rates for delivering services should be attractive to investors so that such a capital-intensive sector can be developed. If social policy insists on rates that do not take into account economically reasonable costs, the regulator or the Government need to ensure the necessary compensatory mechanisms.
- **TO PROTECT CONSUMERS AGAINST MONOPOLIST ABUSES.** The regulator should prevent unjustified rate hikes and any cutbacks in the quality or volumes of residential services. The regulator should establish conditions to make essential services generally affordable.

State regulation and the private sector

The Law “On a statewide program for reforming and developing the residential services sector for 2004–2010” includes private sector involvement, in particular through leases and concessions. The anticipated private investment and the introduction of better management should help achieve the sectoral reform goals identified in the program.

But world practice shows that when the introduction of an effective and transparent regulatory system is left out, the main goals of privatizing public utilities are generally not achieved. Lack of proper laws and regulations and the lack of professionalism, coupled with biased or opaque regulatory processes, make it impossible to set up an environment that might interest providers in expanding access, improving quality, raising efficiency, or investing capital in upgrading their facilities. In some instances, Governments have been forced to nationalize private companies or terminate concessions.

Clear and transparent rules are a pre-condition for private sector involvement to have a positive impact. The particular regulatory system determines market rules, which then reduce market entry risks for private investors and, commensurately, capital costs. Market rules and procedures that are approved and supervised by a regulatory body prevent corruption and politically motivated state intervention in company activities. As the role of the private sector as owners or operators providing essential services grows, regulation ensures the protection of consumer interests.

⁵ See the 20 April 2000 Law “On natural monopolies.”

Regulatory functions and tasks

The main regulatory functions are to regulate prices, ensure quality, and protect consumer interests

The typical functions of state regulation of natural monopolies are to regulate prices, control service quality, ensure competition (access to services) and protect consumer interests. Its tasks are to collect information, to monitor the adherence to rules and procedures, to determine new rules, and to enforce regulatory decisions (see TABLE 3).

Table 3. Typical regulatory functions and tasks

Functions Tasks	Price regulation	Quality regulation	Competition regulation ⁶	Consumer protection
Collect information and data				
	Collect information on current and planned rates and costs;	Get information on the current level of service quality;	Get information on cases of illegal activities or monopolistic abuses.	Survey customers;
	Collect information on consumer price elasticities.	Carry out technical research.		Set up mechanisms for receiving complaints from customers.
Monitor the adherence to the rules and procedures				
	Perform a financial audit;	Oversee the conformity of service quality to established standards;	Investigate cases of monopolist abuse.	Perform a general audit of systems and procedures for disseminating information among customers and the general public.
	Check the correspondence between set and actual rates.	Confirm actual service delivery.		
Develop and adopt new rules				
	Review rates in relation to indexing or changes in the base for calculating.	Set and revise standards and norms for service delivery.	Review complaints about violations of proper business procedures;	Determine service quality standards and norms.
			Organize competitions and tenders.	
Enforce regulatory decisions				
	Revise rates based on changes in company performance indicators;	Require improvements in service quality when necessary.	Change the right of access to networks or services when appropriate or necessary.	Review and settle disputes between customers and regulated utilities.
	Apply fines.			

Source: World Bank (2004), "Contracting out Utility Regulatory Functions," Final Report, January 2004

⁶ Some tasks aimed at ensuring competition can be turned over to other executive bodies. Thus, the Anti-Monopoly Committee oversees the adherence of natural monopolies to legislation governing competition.

Criteria for effective regulation

The regulatory body and the system of regulation should meet these six internationally recognized criteria:

- **CLEAR LEGAL STATUS.** The list of the regulator’s functions should be clearly defined and enshrined in legislation. The functions of policy making, regulation and corporate management need to be separated.
- **INDEPENDENCE.** This requires that the regulatory body is financially and politically independent in its decision-making process. Independence allows a regulator to avoid short-term goals of a politicized nature.
- **ACCOUNTABILITY.** This needs to be ensured through regular reporting and procedures of appeal against decisions made by the regulatory body.
- **OPEN POLICY-MAKING PROCESS.** Key social issues need to be raised at the sessions of the regulatory body in the form of open hearings. Such hearings should allow for representatives of natural monopolies, related businesses, and consumer and community associations to participate.
- **PREDICTABLE REGULATORY DECISIONS.** The regulator should follow a consistent policy. This means meeting Government policy goals for the sector and allowing businesses to plan their activity long-term. Legislation should clearly define the terms and procedures for changing the main powers and responsibilities of the regulatory body.
- **COMPETENCE.** The regulator should employ specialists who have serious expert knowledge and skills (technical, economic, financial, legal) and are able to undertake qualitative and analytical modeling and regulatory impact assessment.

The regulatory body and system of regulation should meet internationally recognized criteria

Alternative state regulatory systems

The Presidential Decree “On measures to implement government policy on natural monopolies” and the Law “On natural monopolies” set out key policy directions with respect to natural monopolies.

Establishing a national regulator

The first option for reforming state regulation is to create a national regulatory commission, which can be set up separately or as a legal entity under the State Residential Services Committee. This option has been chosen in reforming state regulation of the power and communication sectors.

One option is to create a national regulatory commission

Pros:

- clear separation of management and policy-making functions from regulatory functions;
- no conflict of interest in the regulation process;
- more competent regulatory decisions.

Cons:

- high risk of political and financial dependence on the Government, which will greatly affect the neutrality of decisions;

Switching powers from local communities to a central body could prove tricky

- substantial financial resources required to set up and maintain the regulatory body;
- complications in switching powers from local communities to the central body;
- high cost of centralized regulation due to a large number of providers.

Improving the current system

The second reform option is to fix the current system of state regulation. The local nature of monopolies that provide water supplies, heating and sewage is an argument in favor of preserving a decentralized system. Unlike other infrastructure sectors, this local nature explains the more influential role of communities.⁷

DIVISION OF POWERS. The first task in dividing management and policy-making functions in this sector from regulatory functions is to clearly define and enshrine a list of regulatory functions in law. The Law “On residential services” can serve as a basis for distributing these powers.

The distribution of powers should be further improved in three main areas:

Most regulatory functions are entrusted to local governments

- local government bodies should set prices and rates in the residential services sector;
- local state administrations should oversee how local bodies adhere to the state legislation and a single state policy;
- the National Electricity Regulatory Commission should establish rates for heating and hot water for commercial consumers that use combined thermo-electric and heating plants with capacities above the limits set by law. The State Residential Services Committee establishes the licensing of business entities supplying centralized heat, except for those that use combined thermo-electric and heating plants with capacities above the limits established by law.

The Committee provides standards and legal support for reform

While reforms are undertaken, the State Residential Services Committee should:

- develop a concept and a system of regulations on setting prices/rates, standards, norms, procedures, and rules for the residential services sector;
- develop and adopt rules and conditions for the commercial activities of natural monopolies, such as rules for providing water supplies, heating and sewage services to the local population and rules for using heating;
- carry out a systematic revision of regulatory acts that determine consumption norms, costs and losses in supplying water, heating and sewage services in order to bring payments for services in line with their quantity and quality.

The development of terms and rules for licensed activities requires introducing separate accounting for natural monopolies for each type of activity subject to licensing.

⁷ The Law “On natural monopolies” offers the possibility of having executive bodies and local governments regulate natural monopolies, whereas the Presidential Decree “On measures to implement policy on natural monopolies” stipulates that the basic approach to reforming residential services is to set up a regulatory and oversight system for the relevant enterprises involving local governments, community organizations and the public.

SEPARATING MANAGEMENT AND REGULATORY FUNCTIONS. To improve the regulatory system, clear differentiation is needed, within a single body, between state management and state regulation by separating the regulatory process.

This requires the adoption of a special procedure for approving regulatory decisions, that is, those decisions approved in the process of carrying out regulatory functions, in order to:

- make it possible to resolve any conflicts of interest;
- minimize all forms of political and economic interference in the regulatory activities of authorized bodies.

The key feature of such a procedure should be consensual decision-making. To ensure this, specialized teams such as regulatory commissions should be organized within the local governments. These should be independent, open and public.

Regulatory issues should be developed and implemented in a consensual spirit

These special decision-making procedures and the activities of the regulatory commission should be based on legislation that specifies:

- the legal status of regulatory commissions;
- the list of regulatory functions that are carried out in a special order;
- the procedure for setting up regulatory commissions and their composition;
- procedures and criteria for regulatory decision-making;
- a mechanism for financing regulatory activity;
- a mechanism for ensuring the accountability of regulatory commissions.

INDEPENDENCE. Independence in regulatory decision-making needs to be supported through:

The independence of regulatory bodies needs to be secured

- political independence;
- financial independence.

To ensure political independence, it is imperative to create conditions for equal representation of all interest groups in commissions established for consensual decision-making. This task requires developing a special procedure to appoint and dismiss members of regulatory commissions. This should establish:

- the number of commission members. This should be enough to provide for equal representation of all stakeholders;
- the term of office for members of regulatory commissions;
- an exhaustive list of reasons for dismissal;
- legal status for regulatory commission members that will minimize or make it impossible for the head of the regulatory body to influence the process of establishing the commission.

To ensure financial independence and effective performance among commission members, the size of their regular salaries and the source of financing need to be determined.

There has to be accountability and a procedure for appealing the regulator's decisions

ACCOUNTABILITY. This can be ensured through:

- regular reports on activities and decisions made;
- establishing responsibility for any decisions adopted and a procedure for revising illegal/ineffective decisions;
- state oversight to ensure legitimate decisions and proper financial operations.

A mechanism is also needed for annual activity reports by residential services sector regulators. Such reports should include:

- data on financial operations related to carrying out regulatory functions;
- criteria that make it possible to assess the effectiveness and relevance of all regulatory decisions that were approved.

There also needs to be a mechanism for filing complaints against regulatory decisions through judicial and appeal procedures. To ensure that regulators adhere to established rules, it must be made clear what kinds of violations of which procedures and requirements can become grounds for a court to declare a particular regulatory decision invalid.

An appeal mechanism should include setting up steering committees that are authorized to review complaints against decisions by regulatory bodies or other government bodies, and against companies or organizations that infringe upon the interests of market players.

Regulatory activity needs to be open, public and predictable

OPENNESS. The openness of bodies that regulate commercial activity in the residential services sector can be achieved through:

- **Allowing the public in to sessions where regulatory decisions are adopted.** Those sessions of regulatory commissions where regulatory decisions are finalized should be open and public. This means that:
 - any interested individual is eligible to participate in the session;
 - stakeholders and the public-at-large are informed about the agenda in advance;
 - there is a procedure that allows stakeholders to express their opinions and present their arguments.
- **Public decisions.** All adopted regulatory decisions should be made public, as well as the arguments or criteria that supported the decision. The most critical decisions, especially those that are related to rates, should include a procedure for publicly defending the position. A public defense means the voting public is given arguments and counter-arguments in favor of particular choices, along with the data and calculations that confirm the appropriateness and effectiveness of a given decision.
- **Predictable and consistent regulation.** Criteria and methods for regulatory decision-making need to be developed and instituted. These should minimize the likelihood of adopting slanted, ineffective and inconsistent decisions. Both the criteria and the methods should be available to stakeholders.

DELEGATION OF FUNCTIONS TO AVOID CONFLICT OF INTERESTS. Mechanisms for delegating regulatory functions need to be established and written into law. To do so, it is first necessary to prepare two lists:

- regulatory functions and tasks that are the exclusive sphere of regulatory bodies;
- regulatory functions and tasks that can be outsourced and the terms under which this can be done.

There are two types of outsourcing requests with regulatory functions: (1) all recommendations presented by the outside executor are binding and must be implemented; (2) the regulator can choose among several alternatives. Since political independence is weaker in the second arrangement, it is not always an effective approach.

COMPETENCE. To make regulatory bodies more competent, specific requirements for the members of regulatory commissions must be established, including: an appropriate education, professional experience, and so on.

Some regulatory functions can be delegated to outside organizations and individuals

Regulatory bodies must be competent

SOCIAL POLICY

The state is supposed to guarantee all citizens access to water, heating and sewage, as these are essential services. The basic feature of these services is their universal nature: they should be affordable and accessible, and their quality should be reliably high. This means that all residents, including the poorest, can use these services. Since rates as much as possible reflect the real cost of providing these services, the poorest individuals can afford them only with state support. In Ukraine, such support takes the form of privileges, meaning free or discounted delivery, subsidies, and social assistance to low-income families. Although every type of support has its drawbacks, subsidies seem to be the most acceptable

Universal services

Water supply, heating and sewage are universal services

Access to the services of natural monopolies in the residential services sector—water supply, heating and sewage—is essential for humans to have a decent basic quality of life. These universal services are distinguished by their ubiquitous nature, uniform and highly standardized quality, and broadbased accessibility. This means that these services have to be delivered at a proper level of quality at prices that are fair, reasonable and affordable for the population, including for the poorest.

However, such universal services are often unprofitable for the provider, especially in remote or rural areas. These losses should then be compensated to the provider through higher rates or subsidies.

During soviet times, the cost of water supply, heating and sewage for residential users was artificially low. In the 1990s, the rejection of centralized planning and cutbacks in Budget subsidies for the residential services sector resulted in growing costs for delivering these services to the end-user.

Market transformations and liberalized rates, in particular for fuel and energy, also added to delivery costs for residential services, pushing rates even higher. During the first decade of independence, utility rates grew 16 times more than prices for all other consumer goods and services.⁸ With a population that was gradually growing poorer and an income gap that grew larger, affordability of water, heating and sewage services became a problem.

Although rates have grown dramatically, they still do not cover the costs of delivery

Despite their significant growth since Ukraine became independent, utility rates still do not cover the real costs for providing these services. This means that any reform of the water supply, heating and sewage markets will be accompanied by further rate hikes. This is likely to have a further negative impact on the capacity of impoverished households to pay for the services. At the same time, at a certain minimum consumption level, demand for water is inelastic in terms of prices. This means that, if residential rates continue to grow, the state needs to guarantee all its citizens access to a basic amount of water of a proper quality.

The criterion for affordability

In world practice, the criterion for accessibility is extremely broad: the maximum portion of its income that a household can afford to spend on water supply and

⁸ See OECD Report “Key Issues and Recommendations for Consumer Protection: Affordability, Social Protection, and Public Participation in Urban Water Sector Reform in Eastern Europe, Caucasus and Central Asia,” 2003.

sewage services. In other words, there is no single international benchmark. Different organizations and experts identify different levels:⁹

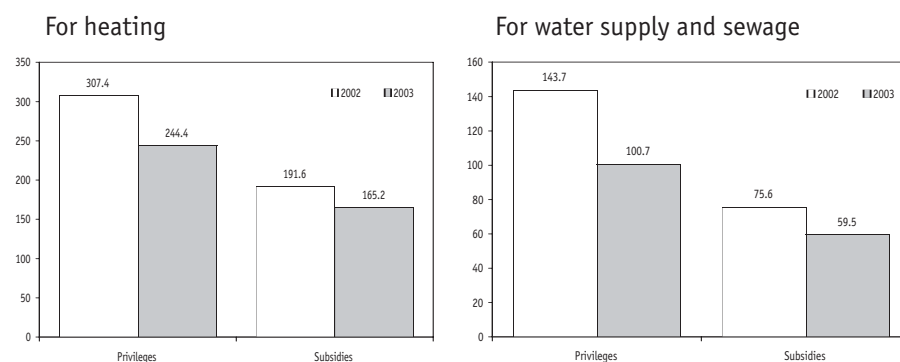
- services in OECD countries are considered affordable if the average household spends no more than 1.5% of its income to pay for them and very expensive if the cost rises to 3–5%;
- the World Bank and EBRD set the average cost of services at no more than 4% of household incomes;
- the US’s EPA says that a household with median income should not spend more than 2–2.5% of its pre-tax revenue to pay for such services.

Two-pronged support for consumers

Since independence, the Ukrainian Government has gradually developed a two-component system for supporting low-income households:

- **cross-subsidies** through differentiated rates for residential and industrial consumers. On average, water supply rates for industrial consumers are triple residential rates (see **RATE POLICY**). In effect, industrial customers subsidize services for residential customers;
- **direct support** by providing privileges and subsidies for households to pay for their services, and social assistance to low-income families. With rare exceptions, both privileges and subsidies for residential services are provided in non-cash form: consumers pay a part of the cost, in particular for water supply and sewage, while the rest is covered from the Budget. Unlike subsidies, privileges are not income-based.

Figure 1. Privileges and subsidies charged by year-end, UAH mn



Source: State Residential Services Committee

⁹ Ibid.

¹⁰ Such exceptions are pilot projects to give privileges and residential subsidies in cash form. In 2004, pilot projects were launched in Brovary and Brovary county, Kyiv oblast, and in Smila county, Cherkasy oblast, in response to Cabinet Resolutions №483 “On a pilot project to provide specific population groups with cash benefits to pay for residential services and fuels” of 14 April 2004 and №725 “On a pilot project to provide households with cash subsidies to compensate the costs of residential services, LNG, and solid and liquid heating fuel” of 2 June 2004.

Residential subsidies

In 1994, Ukraine began to switch to a new system of payments for residential services, which has led to a steady growth in the portion of household spending going to pay for these services. Shortly afterward, in 1995, the Government introduced a system of residential subsidies¹¹ to protect low-income households. These subsidies cover residential maintenance and utility services such as water supply, heating, gas, sewage, electricity, and garbage collection. Such families have to pay a portion of the utility costs themselves, while the rest is picked up by the state.

Residential subsidies are one way to support the poor

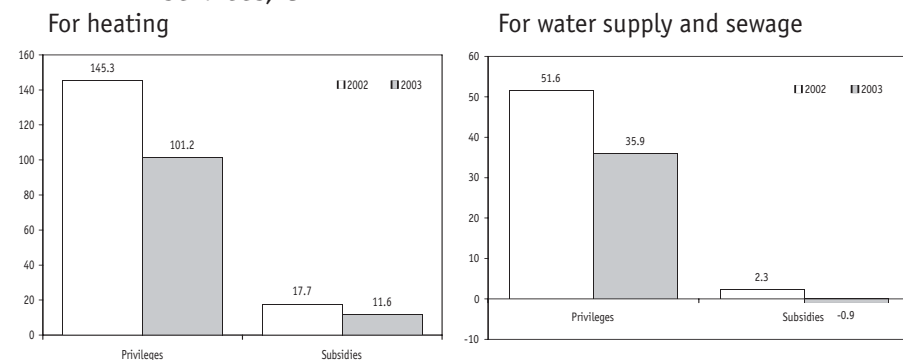
The residential subsidy is a targeted benefit to low-income families, generally provided in non-cash form. It is later compensated to service providers, often also in non-cash form as mutual offsets. As a rule, households become eligible for residential subsidies when the cost of residential services, within established consumption norms, exceeds 20%¹² of average monthly total household income. Consumers pay this portion of their bills, while the rest is a non-cash subsidy.

Eligibility is determined by subsidy departments or offices under local administrations after an individual has personally applied for a residential subsidy. They are normally valid for six months, or a year if the household consists of pensioners and other disabled individuals whose only source of income is a pension, social benefits, or income from subsistence farming. When this term expires, beneficiaries have to confirm their continuing eligibility for the next term.

The norm for spending on different services and, thus, the size of the subsidies is determined separately for each type of service relative to its share in the overall costs. If the cost of a particular service changes during the period for which a subsidy is in effect, the subsidy is re-calculated for that service alone. Subsidies are financed by local budgets using subventions from the State Budget.

In August 2004, 6.2% of households claimed subsidies and the average subsidy was UAH 31.¹³

Figure 2. Arrears in payments for privileged or subsidized services, UAH mn



Source: State Residential Services Committee

¹¹ See the 4 February 1995 Cabinet Resolution №89 “On providing households with subsidies to compensate the costs of residential services, LNG and solid heating fuel.”

¹² A limit of 15% of total household income for spending on residential services was set for households consisting entirely of pensioners and other disabled individuals, provided that there are minor children or Group I/II invalids as well and the average monthly per capita income is no more than 50% of the minimum subsistence level.

¹³ The share of households receiving subsidies tends to rise during the heating season. The peak number of beneficiaries is registered in November. This is caused by a seasonal combination of rising costs for residential services and declining household incomes.

The main advantage of residential subsidies as a means to ensure low-income households access to residential services is their targeted nature: a subsidy is granted only upon application and its size is related to income. Still, there are a number of problems with the way that subsidies are being managed by the state:

The targeted nature of subsidies is a key advantage, but there are drawbacks

- **service providers not fully compensated.** Budget arrears to residential service providers were UAH 18.8mn as of August 2004;
- **overstated consumption norms, especially for water.** Subsidies for water supplies are provided on the basis of consumption norms set, as a rule, by local councils. These norms are based on old soviet sanitary standards and far exceed the minimum necessary to satisfy basic human needs. According to experts, sanitary norms for water consumption need to be replaced with calculated social norms. These will be lower than the old sanitary ones but they will be guaranteed and will encourage more economic consumption of water;
- **subsidies not restricted to low-income households.** A large share of Ukrainian households has unreported incomes.

Privileged residential services

The current system of privileges was also established under the soviets. At the time, privileges were intended mainly for special contributions to the country or to individuals in high office. In other words, they were designed to distinguish these groups of the population even more from the rest. In 1990s, declining living standards resulted in a massive expansion of the beneficiary base to include World War II veterans, Chornobyl disaster victims, and representatives of various professions. To a great extent, privileges began to fulfill the function of social security.

Privileged residential services can be categorized as a right to discounted or free services. According to law, this discount can be 20%, 30%, 50%, 75%, or 100% of the cost of services, based on average usage norms.

Privileges are generally provided to certain social or professional categories, such as participants of military operations, war veterans, Chornobyl victims, police officers, service personnel, and so on. As a rule, privileges apply to members of the beneficiary's immediate family as well.¹⁴ Moreover, the size of a privilege does not depend on the beneficiary's income.¹⁵ As the incomes of individuals who belong to a particular category can vary a great deal, the Government ends up providing support equally to the very poor and the relatively well-off. Privileges are also financed by local budgets through subventions from the State Budget.

Privileges have no relation to income

The current system of privileges has a number of problems:

- **not effective as social security because not income-based.** This is confirmed by the fact that many households that already enjoy privileges also apply for subsidies. Indeed, among subsidized residents, 16–20% of Kyiv families had priv-

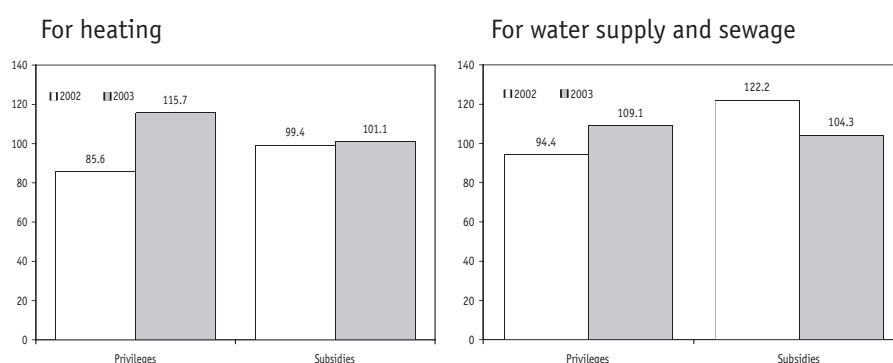
¹⁴ According to the 2004 Budget Law, "immediate family" is now limited to: the beneficiary's spouse, minor children, unmarried adult children who have been Group I or II invalids since childhood or who have become Group I invalids, any caretaker residing with a Group I disabled veteran (provided this veteran is not married), disabled parents, and an individual in the care or guardianship of someone who is eligible for privileges and resides with the beneficiary.

¹⁵ Except for service-based privileges. According to the 2004 Budget Law, these are provided only to beneficiaries whose incomes are below the minimum subsistence level (UAH 386.73 for able-bodied individuals).

ileged residential services¹⁶ in 2001. In other words, the amount of privileges allocated to the poorest is not enough to increase their incomes to a level that would allow them to drop the subsidy;

- **lack of a system for tracking beneficiaries and the extent of privileges granted.** This makes it difficult to assess the cost of the privileges and to plan appropriate financing for them in the Budget. This leads to incomplete compensation for the services delivered by providers;
- **overstated consumption norms, especially for water.** This removes any incentives to economize;
- **freeloading mentality encouraged.** Consumers develop poor payment discipline, as the impression among the general population is that they can use services without necessarily paying for them.

Figure 3. Settlements for privileged or subsidized services, %



Source: State Residential Services Committee

Social support for poor families

State support for poor families should raise their incomes...

According to the 1 June 2000 Law “On social support to low-income families,” families whose income is below the minimum subsistence level¹⁷ are eligible for state support. The aim is to raise incomes rather than subsidize expenditures. The Law defines the size of support as the difference between the minimum subsistence level for a family and its incomes.

However, until the country’s economy stabilized, the size of this support was determined by the realities of Budget resources. As a result, the Government introduced a concept called the guaranteed minimum subsistence level, that is, the level the state guaranteed for an individual.¹⁸ In 2001, this level was UAH 50 and in 2002–2004 UAH 80.¹⁹ Thus, if the average household per capita income was below this level, state support was calculated as the difference between the guaranteed minimum level and the actual income.

¹⁶ See the PADCO Analytical Review №3 “Privileges for Residential Services,” December 2001.

¹⁷ In a household, this means the sum of minimum subsistence levels for all family members.

¹⁸ This level is far lower than the minimum subsistence level. The Law “On the minimum subsistence level for 2004” set the following minimums: UAH 324.49 for children under 6, UAH 404.79 for children aged 6–18, UAH 386.73 for able-bodied adults, and UAH 284.69 for unemployable adults.

¹⁹ In 2004, the guaranteed minimum subsistence was differentiated as: UAH 80 for able-bodied adults, UAH 110 for the unemployable, and UAH 115 for the disabled.

Families whose incomes are below the guaranteed minimum subsistence level are eligible to apply for subsidies. This is why the impact of social support for low-income families in expanding access to water supply, heating and sewage services remains low at this stage. If, on the other hand, the Government could guarantee the official minimum subsistence level, this would mean an increase in the capacity of low-income families to pay for services and many families would lose the right to a subsidy.

...but they remain extremely low

Options for social policy: goals, principles and tools

Goals and principles

To ensure a social net for consumers serviced by natural monopolies, it is important to:

Social security should guarantee poor families access

- provide poor households with access to a reasonable minimum level and proper quality of water supply, heating and sewage;
- improve payment discipline.

The key principles of social policy in providing access to water supply, heating and sewage are:

The key principles should be equitable support and accessible services

- equity: equal social protection should be provided to consumers in similar circumstances;
- affordability: as these services are essential, the poor should have access at a minimum price, that is, with the help of subsidies.

Social policy tools/options

To provide social security to the poorest users of residential services, world practice applies a range of dissimilar mechanisms or combinations thereof:

World practice shows different approaches

- direct subsidies;
- cross-subsidies;
- privileges;
- poverty alleviation programs.

DIRECT SUBSIDIES. Subsidies can be given to:

- *providers of water, heating and sewage services* if established rates do not cover their costs. This type of subsidy can be effective in supporting service providers during a transition period, in particular when consumers have to pay a larger portion of service costs;
- *low-income consumers.* This effectively ensures access to the poorest consumers. However, it requires: a clear mechanism for identifying which households need support, sufficient institutional capacity, and huge administrative costs for implementation and maintenance.

CROSS-SUBSIDIES. This means establishing differentiated payments for different consumer categories. World practice recognizes two main types of cross-subsidies:

- 1) *by consumption type*. Subsidizing residential users at the expense of industrial customers is the most widespread approach: industrial rates are set higher than residential ones;
- 2) *by region*. This type of subsidy is based on the principle that consumers belonging to one category pay the same rate regardless of where they reside or the real costs of providing water, heating and sewage services.

The key drawback of cross-subsidies is that they distort economic incentives for different economic agents and encourage inefficiency.

RATES DIFFERENTIATED ACCORDING TO CONSUMPTION. Regulatory bodies in different countries establish block rates, that is, rates per unit are raised once a certain consumption threshold is passed. This makes it possible to encourage conservation, especially of water. This type of rate differentiation can also be regressive, so that large families or several families using a common connection end up paying at a higher rate.

PRIVILEGES FOR RESIDENTIAL SERVICES. Generally, privileges are ineffective as social security as they are not income-based. For this reason, many countries have reformed this system or are currently doing so. They can, however, be more effective than targeted subsidies due to lower administrative overheads, if belonging to a certain category is the criterion for eligibility, i.e., being poor.

POVERTY ALLEVIATION PROGRAMS. These are more appropriate when water supply, heating and sewage services constitute an insignificant portion of household spending.

How to provide social security during reform

Bringing order to the system of privileges...

Among the short-term objectives of providing direct support for households is bringing order to the system of privileges, that is:

1. Preventing any increase in the number of beneficiaries. The Government needs to develop and apply new mechanisms for providing social security and guarantees for those individuals who are on special state assignments, such as service personnel and other individuals involved in Ukraine's military effort in Iraq.
2. Improving the tracking of granted privileges:
 - prepare an inventory of privilege beneficiaries; set up a unified state register of those who use or are eligible to use privileges according to current legislation;
 - update this register periodically, such as every six months, by requiring beneficiaries to confirm eligibility;
 - allow residential services providers to regularly check eligibility rules using the register.
3. Regulating privileges:
 - replace sanitary norms with social norms for residential services;
 - stop extending privileges to a beneficiary's immediate family.
4. Introducing full compensation of costs to monopolies providing residential services.

5. Introducing targeted allocation of privileges in cash form.²⁰ On one hand, this will improve the tracking of beneficiaries and the payment of real costs to services providers. On the other, it will encourage more economical consumption among beneficiaries—provided they have water meters—since the size of the benefit will have no relation to the amount of consumption.

If these objectives are reached, the financial standing of residential services providers should improve as the volume of privileged services goes down while tracking and compensation become more transparent.

...should improve the financial standing of service providers

Because privileges are not effective as a form of social security, in the long run they should really be replaced by residential subsidies and other forms of targeted benefits. Switching to residential subsidies in cash form, currently being piloted in several regions (see Fn. 10), will mean that revenues go directly to providers, which should increase their operating capital.

In order to encourage payment discipline alongside privileges and cash subsidies, payment requirements have to be enforced properly. The threat that they will lose their subsidies and privileges if they do not pay for their portion of residential services could prove an effective control mechanism with consumers.

While the role of residential subsidies can be reduced once the state begins to guarantee a minimum subsistence level in the amount set forth in law, it cannot be cancelled altogether. Poverty alleviation, particularly social support for low-income families, cannot guarantee payment discipline, but subsidies offer real incentives for timely payment, as this is a condition for receiving them.

In the long run, privileges should be replaced by subsidies

²⁰ Specifically, pilot projects to provide privileges in cash form (see Fn. 10) should clarify the advantages of such an approach.

FINANCIAL POLICY

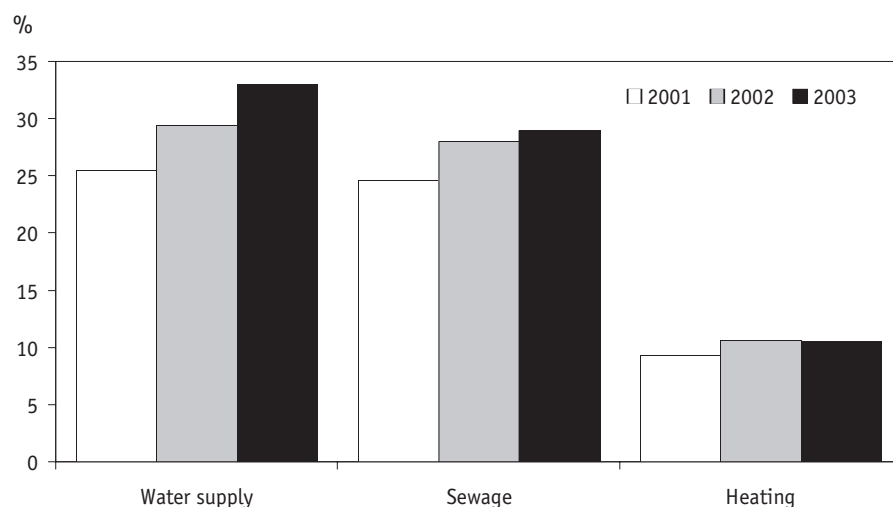
A need to urgently reconstruct and renew fixed assets used in water supply, heating and sewage services requires that current investment policy be completely re-thought. Traditional sources for financing capital investments such as local budgets and enterprise funds can do little to improve the situation. Residential services providers lack the capacity to finance a program of full technical re-equipment using their own capital, while partial and occasional re-equipment of separate facilities does not substantially lower the overall cost of services. Local budgets also lack the necessary resources to subsidize investment in the sector. Although this problem can be resolved by involving the private sector, so far the measures taken by the Government have not produced results for lack of focus and because key regulatory issues keep being postponed

Major repairs, reconstruction and development remain half-hearted...

What is the state of fixed assets?

The legally established procedure for compensating the costs of water supply and heating providers does not take into account necessary major repairs, reconstruction and development; for replacing worn-out pipelines, pumping equipment and filtering plants; and for upgrading to modern water purification and disinfection systems. According to State Residential Services Committee estimates, the reconstruction of broken-down facilities will cost about UAH 50bn by 2010.

Figure 4. Outdated or collapsing networks



Source: State Residential Services Committee

Most of Ukraine's water purification plants were built 20–60 years back using outdated construction standards. The current water-purifying system used by pipes that draw water from open reservoirs cannot ensure the necessary quality of water.

Overly centralized heating and the use of inefficient and worn-out equipment in boiler-rooms, heating junctions and networks mean significant heat losses and unreliable heating. Service providers also suffer substantial losses because of frequent accidents and large volumes of repairs.

The heating and distributing networks of residential buildings and community facilities such as hospitals, kindergartens, schools, have long passed their standard

lifespan. The rate at which worn-out network pipelines are replaced is below norm and does not match reliability standards. As funding shrinks, worn-out heating systems are replaced less and less regularly.

...leading to line losses and unreliable supplies

Capitalizing fixed assets

Investment capital for water supply, heating and sewage plant could come from local budgets, enterprises themselves, and outside investors. However, an uncertain regulatory environment and inappropriate rate-schedules discourage the commitment of capital from all three sources.

Financing through municipal budgets

A city council decision is required in order for the municipal budget funds to go into residential services. A comparison across selected cities²¹ shows that this kind of investment is extremely low, mainly because of:

Municipal budgets provide little investment

- limited local government resources;
- lack of practice of local borrowing;
- lack of incentives.

Investment through company funds

A lion's share of fixed investment in the residential services sector comes from the enterprises themselves. However, these funds are extremely limited because of low profitability or even unprofitability due to:

Most fixed investment comes from enterprises themselves

- inefficient use of existing resources;
- huge defaults by consumers for services rendered;
- the failure of residential service rates to reflect all legitimate costs;
- local budgets that do not compensate privileges provided to low-income individuals.

Attracting outside investors

The sector is not attractive in terms of investment because it presents a number of risks for potential investors:

The residential services sector presents a number of risks

- the current rate policy of local governments is aimed only at taking care of the social welfare of the local population. This makes it hard to determine the rate of return in a sector that requires large fixed investment;
- taking advantage of the option to stop providing services to deadbeat consumers is limited by the technical nature of water supply, heating and sewage networks.

Borrowing capital

Ukraine does not have a history of using innovative approaches to finance residential services providers, such as issuing bonds, attracting funds secured by insurance carriers, or leasing equipment to utilities.

Innovative financial approaches are not widespread

²¹ According to Ministry of Economy and European Integration data, 2002.

Prospects for local government investment

Locally elected governments have three main sources of revenue that they can partly use to finance the cost of maintaining and developing local infrastructure: land taxes, local taxes and fees, and corporate profit taxes levied on public utilities. This share ranges from 10.7% to 46.5% of revenues, depending on the level of budget, and amounts to a paltry 1.6% of GDP. Revenues from local taxes and fees are currently a miserly 0.8% of GDP. In short, these resources cannot cover the sector's fixed investment needs. Expanding the fiscal capacities of local governments means tackling the larger problem of providing local governments with reliable and adequate resources. Among possible solutions are introducing property tax at the local level and adding a local surtax to personal income taxes.

One huge internal investment reserve that local governments can take advantage of is emissions credits. Using these as a commodity to attract foreign investment requires few additional financial resources, but it does need legislation for setting up municipal energy-conservation systems and incentives to save energy—both of which are currently lacking.

The use of credit to finance investment is limited by law in Ukraine. Other than short-term loans, the Budget Code restricts the right to borrow at the local level, making it the prerogative only of the Crimean Rada and city councils, while international loans can only be undertaken by city councils in municipalities with a population over 800,000. Moreover, except for short-term loans, money can be borrowed only for development purposes and the cost of servicing the debt should not exceed 10% of the general fund.

At the moment, it is difficult to analyze the impact of such restrictions. One reason is that the Cabinet of Ministers approved a Procedure for borrowing for local budgets only in 2003. Without such a procedure, there was no way for this source of financing of local budgets to evolve.

After Odesa defaulted on its bond issue in 1997, municipalities re-emerged on bond market only in the 2000s. In August 2003, Kyiv issued Eurobonds worth a total of US \$150mn. These Eurobonds will mature in five years, yielding 8.75% pa. Zaporizhzhia is currently issuing bonds for UAH 25mn, and Kharkiv and Donetsk city councils have announced plans to issue bonds as well.

However, overall such borrowings are not playing an important role as a source for local development or as a policy tool. Since this makes it highly unlikely that local budgets will allocate enough funds to development in the medium run, a serious problem is brewing. With an absolute majority of infrastructure assets in residential services largely worn out, new capital is desperately needed. Yet it will be impossible to attract until there is a well-developed lending market.

One way of financing the sector is loans from IFIs to develop and revive water supply, heating and sewage systems. Such projects include:

- loans from the World Bank to support: the Sevastopol Heating System Improvement Project (total cost:²² US \$36.1mn); government guarantees to attract loans for the “Lviv Water and Sewage Project” (total cost: US \$40.8mn); “Kyiv Public Buildings Energy Efficiency Project” (total cost: US \$30.39mn); and “Kyiv District Heating Improvement Project” (total cost: US \$249mn);

²² The total project cost includes loans from the IFIs and the resources contributed by the Ukrainian side and other donors.

- EBRD projects: “Zaporizhzhia Water Utility Development and Investment Program” (total cost: US \$42mn) and a Plan of EBRD medium-term measures in Ukraine’s municipal and environmental infrastructure.

Government policy aimed at improvement

The Government has made several attempts to improve the replacement of fixed assets. In 2001, it approved a Concept for a depreciation policy in Ukraine. Measures in the Concept are aimed at providing financial incentives for companies to use depreciation funds²³ to invest in fixed assets.

The Government has made several attempts to improve the replacement of fixed assets

The Concept provides:

- several methods for charging depreciation and a possibility for companies to choose among specific depreciation methods;
- the right to independently establish concrete service life terms for fixed assets;
- tax rebates to companies who reinvest depreciation funds.

Steps taken by the Government to raise the sector’s attractiveness to investors included a special investment regime²⁴ in Kharkiv, setting up a special economic zone (SEZ) called Port Crimea, which offered a number of breaks to water supply and distribution projects. In addition, the Law on SEZs in Shostka names heat generation and distribution a priority area. However, an analysis carried out by the Ministry of Economy and European Integration shows that these SEZs have seen hardly any investment in water supply or heating.²⁵

An analysis of the situation in the sector shows that tax pressure is not the factor restraining investors. Financial and lending institutions find the residential services sector unattractive due to financial instability and uncertainty related to regulation. The lack of guarantees that capital will be returned limits alternative mechanisms for funding long-term projects, such as through bond issues, financial leasing, energy-conservation service contracts involving equipment producers and energy servicing companies, and private sector investments.

Financial institutions find the sector unattractive for investment

Most residential rates not only fail to reflect the investment component, but do not even cover the complete costs of producing and providing residential services.²⁶

²³ A feature in Ukrainian accounting where depreciation accumulates.

²⁴ The laws on several SEZs allow for a company implementing an investment project to be exempted from profit tax (on that part of its profits coming from the investment) for 3 years, based on a contract with the relevant local council. Profits in the fourth through the sixth year are to be taxed at 50% of the normal profit tax rate. This breaks kicks in when the first profits are reported.

²⁵ The provision of SEZ tax breaks to investment projects worth at least US \$1mn based on supposedly high risks seems to have been overstated and has made it difficult to objectively assess the impact of tax breaks on the development of this sector.

²⁶ Some regions do include profits in their calculations, with due consideration of the investment component, but it is included only in industrial rates for water supply and sewage (in particular by Chernihiv, Mykolayiv, and Odesa oblasts) and does not fully cover capital investment costs.

Private sector involvement as an option

The private sector can provide both investment and good management

A key argument used by supporters of private sector involvement is the need to upgrade worn-out equipment and ensure more effective management.

In choosing what policy to follow in this area, the Government should consider four factors:

- water supply, heating and sewage markets are natural monopolies. This means that they cannot provide the necessary conditions for consumers without state intervention;
- as these services are the responsibility of local governments, private sector involvement often requires that issues of jurisdiction be settled first;
- a large portion of the sector's infrastructure is underground, which makes it difficult to get an exact picture of its condition. This increases the cost of preparing assets for privatization and raises the likelihood of conflicts after assets have been transferred into private ownership or operation;
- given the importance of water quality for public health, the Government should continue to oversee this area after privatization in any form.

In addition, raising the interest of investors in this sector has to be preceded by:

- assurance that an acceptable ROI, which means that rate-setting policy must take the investment component into account;
- assurance that the Government has identified a consistent social policy that it intends to adhere to. Investors should be certain that the social and political situation will not influence rate-setting.

Forms of private sector involvement

Depending on the degree to which the private sector is involved, there are several forms that its participation can take on:

1. **SERVICE CONTRACT.** As a rule, this is a short-term contract where the contractor is not directly responsible for providing services, but has particular tasks to fulfill.
2. **MANAGEMENT CONTRACT.** This is similar to the sub-contract, but payment for the contractor's services depends on performance indicators.
3. **LEASE.** This means that a private sector partner undertakes the risks related to the delivery of services, including responsibility for infrastructure management and maintenance.
4. **CONCESSION.** This is an agreement that places responsibility for construction and fixed investment on the partner. When a concession expires, the assets return to state ownership. There are two forms of concession: BOT (build–operate–transfer) and ROT (rehabilitate–operate–transfer).
5. **BOO (BUILD–OWN–OPERATE).** This scheme does not entail transferring the assets to the state. A private company is responsible for investing enough to reach certain goals written into the state licensing agreement.

The degree of involvement determines the form of this involvement

Choosing the best form

The choice of a form for private sector involvement is affected by four factors:

- **THE TECHNICAL NATURE OF THE INFRASTRUCTURE, SERVICE STANDARDS, AND THE RELIABILITY OF INFORMATION ABOUT THESE.** Absent or inaccurate information on the state of the physical networks, human resources and financial indicators complicate the conclusion of long-term contracts.
- **THE REGULATORY ENVIRONMENT.** This means both general laws affecting private initiatives, sector-specific legislation, and special standards that affect rate-setting in the sector and regulate quality standards. It should be possible for legislation to be quickly amended if necessary.
- **THE SUPPORT OR RESISTANCE OF KEY STAKEHOLDERS.** For different forms of private sector involvement to be successful, it is important to identify potential sources of stakeholder dissatisfaction and search for compromise at the initial stages.
- **THE FINANCIAL VIABILITY OF ANTICIPATED ACTIONS.** Here, the key question is how possible it will be to recover any losses by raising rates. Is it realistic to expect that private sector will make the sector more efficient? If not, are consumers ready to pay higher rates? If this is not an option, is it possible for different forms of state assistance to protect vulnerable groups?

The general impact of each factor is presented in simplified form in **TABLE 4**.

In short, Ukraine offers conditions that suit only simple forms of private sector involvement, such as service or management contracts. As these forms do not resolve the issue of capitalizing fixed assets, more complex options could potentially be beneficial for consumers and government alike. This means that tackling regulation and rate-setting and identifying social security policy goals and approaches should become government priorities in this sector.

Choosing how to involved the private sector depends on the regulatory environment

Service and management contracts are the best form at this stage

Table 4. Prerequisites for the success of different private sector options²⁷

Private sector option	Stakeholder support and political commitment	Cost-covering rates	Reliable and full information about the state of the system	Developed regulatory environment	Good country credit rating	Potential benefits of this option
Service contract	Unimportant	Not necessary in the short term	Possible to proceed with only limited information	Minimal monitoring capacity needed	Not necessary	Low
Management contract	Low to moderate levels needed	Preferred but not necessary in the short term	Sufficient information required to determine incentives	Moderate monitoring capacity needed	Not necessary	
Lease	Moderate to high levels needed	Necessary	Quality information required	Strong capacity for regulation and coordination needed	Not necessary	
BOT (build-own-transfer)	Moderate to high levels needed	Preferred	Quality information required	Strong capacity for regulation and coordination needed	Higher rating will reduce costs	
Concession	High levels needed	Necessary	Quality information required	Strong regulatory capacity needed	Higher rating will reduce costs	

²⁷ Source: Penelope J. Brook Cowen, "The Private Sector in Water and Sanitation—How to Get Started" from *The Private Sector in Infrastructure*, World Bank Group, 1997, p. 92.

RATE POLICY

An important part of regulatory reform—and a guarantee of successful residential services reform—is changing the principles and procedures underlying residential services rating policies. So far, there has been no model for effective rate regulation, yet rates are set under the influence of social and political conditions. As a result, regulation is not done in the open, the financial stability of providers is not secure, and the welfare of consumers is not fully ensured. The gradual introduction of internationally recognized principles and procedures of rate regulation could help cast more widely for investment and increase the efficiency of production activity

What's wrong with rate-setting methods today?

Legal options and rate regulation

A number of legislative acts regulate prices on the centralized water supply, heating and sewage markets. In particular the Law “On prices and pricing”²⁸ establishes four regulatory approaches:

- setting fixed prices/rates and price/rate caps;
- regulating supply and delivery mark-ups;
- setting profit margin norms;
- introducing mandatory declaration of changes in prices and rates for specific types of products, goods and services.

According to the Law “On natural monopolies,” the focus of regulation on markets that are dominated by natural monopolies is prices or rates for services, universal access to services provided or delivered, and other aspects of commercial activity in the sector. The law stipulates that the regulation of rates should reflect:

- costs related to production and delivery of services;
- investment needs;
- projected profits from service delivery;
- the remove of different consumers from the service production site;
- the correspondence between service quality and consumer needs;
- government subsidies and other forms of state support.

Inconsistent distribution of the power to set and regulate rates makes it harder to institutionalize the process of regulating rates. According to the Law “On local state administrations,” oblast state administrations currently have the power to regulate rates for residential services, determine and set consumption norms, and oversee adherence to these norms. At the same time, they have lost the leverage of managing what are now public utilities that have changed owners. Meanwhile, the

Rates are at the heart of regulation on markets dominated by natural monopolies

Unclear division of regulatory powers complicates the regulation of rates

²⁸ See also the 25 December 1996 Cabinet Resolution №1548.

Law “On local government” places the duty to provide residential services on municipal, village and township councils and their executive committees.

As of 1 July 1998, the Verkhovna Rada cancelled subsidies for the difference in rates and simultaneously adopted the Law “On a moratorium on rate hikes for residential services and public transit services provided to citizens of Ukraine.” In 2000, infringements of the cost-recovery principle were removed.

In 1999, the basis for rate regulation was changed

The rate-setting methods based on established normalized costs and fixed rate of return inherited from the FSU were in effect until April 1999. Current rate regulation methods²⁹ include three new elements:

- the level of economically sound rates is based on planned operating costs that use technologically based standards and economic arguments, not the previous year’s levels;
- capital costs, especially long-term, can be built into rates;
- operators can be solicited through tenders and set two-part rates.

Problems today

Residential services have no effective rate regulation system

There are two sets of problems with current rate regulation methods and the state of the residential services sector: (1) there is no model for effective rate regulation; and (2) rate-setting is largely affected by social and political conditions, where low rates are maintained, but the quality of provided services is not ensured.

1. THERE IS NO MODEL FOR EFFECTIVE RATE REGULATION.

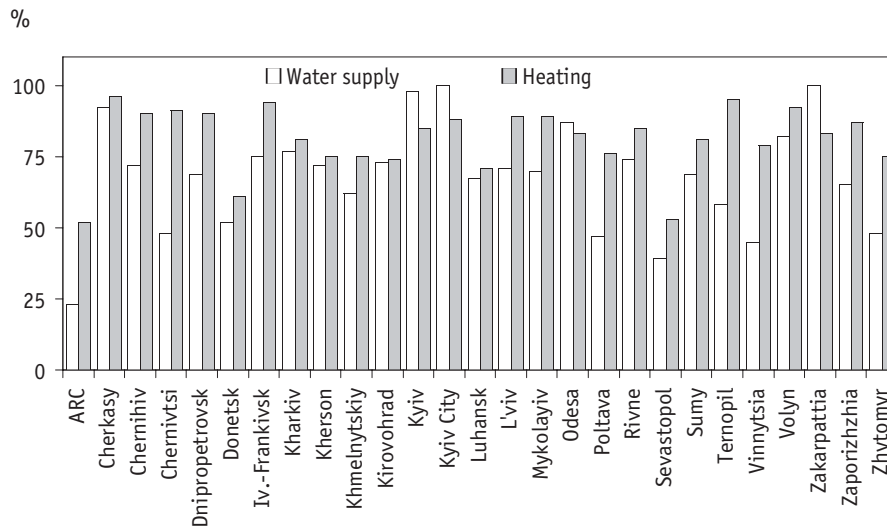
- Cost-plus rates facilitate neither higher operating efficiency nor proper investment planning.
- Regulation is not open and public:
 - there are no established procedures for public involvement in debating rates before they are approved;
 - regulatory bodies do not track contract violations;
 - there are no indicators against which to compare the implementation of approved plans.
- Regulatory procedures have not been established by a regulatory body:
 - there are no timeframes and procedures for setting or revising rates;
 - there is no complete list of documents that need to be submitted to a regulatory body;³⁰

²⁹ See a “Procedure for setting rates for centralized water supply and sewage services” developed by the State Residential Services Committee in 1999 and adopted by the State Construction and Architecture Committee on 27 June 2001 and a “Procedure for setting rates for thermal energy and centralized heat supply services” developed by the State Construction and Architecture Committee in 2000. The latter is expected to be adopted in 2005.

³⁰ This is required by the 11 September 2003 Law “On the principles of regulatory policy” and the 11 March 2004 Cabinet Resolution №308 “Methods for analyzing regulatory impact.”

- when rates are being raised no effective mechanism is used for indexing specific items. When electricity and material prices are on the rise and the minimum wage is raised, residential services costs also go up. As there is no mechanism for a “real time” rate adjustment, service providers’ losses go up as well, while cutbacks in resources only have a negative impact on the quality of the services.

Figure 5. Compensation of service costs by residential consumers in 2003



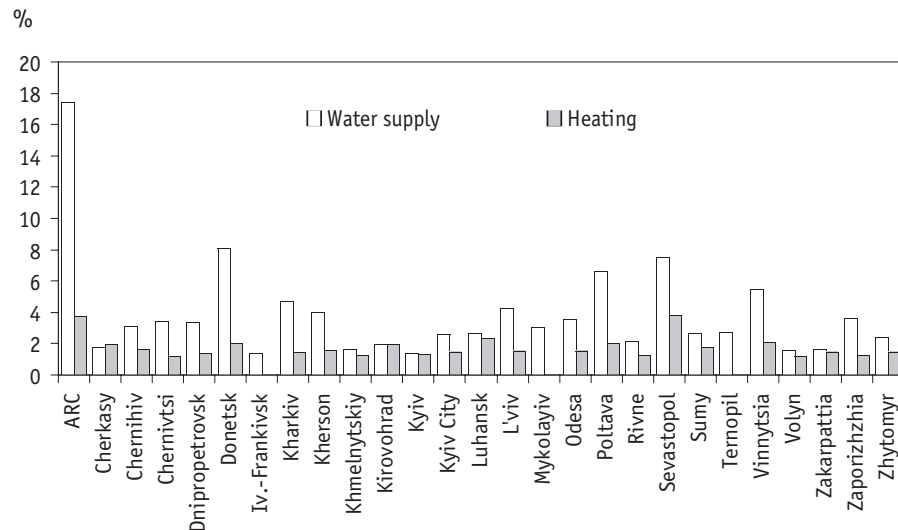
Source: State Residential Services Committee

2. RATE SETTING IS AFFECTED BY SOCIAL AND POLITICAL CONDITIONS.

- An overly high level of cross-subsidies distorts economic incentives for both residential and industrial consumers. Residential consumers either over-consume cheap services or are forced to opt out of centralized services because they are too costly.
- Financial stability is not a priority. In 1998–2003, nearly all companies providing water supply, sewage and centralized heating were below the break-even point.
- The service quality remains low. This supports soft budget constraints and reduces incentives for consumers to fulfill their obligations. Consumers do not want to pay for low-quality services, but they are also not prepared to pay more because they do not trust the service providers.
- Consumers are not fully protected:
 - there are no contracts between service providers and consumers;
 - there is no monitoring of the service quality indicators;
 - there is no mechanism to take account of service quality when setting rates for services.

Cross-subsidies distort economic incentives for consumers

Figure 6. Cross-subsidies in 2003



Source: State Residential Services Committee

Rate regulation as a means of attracting capital

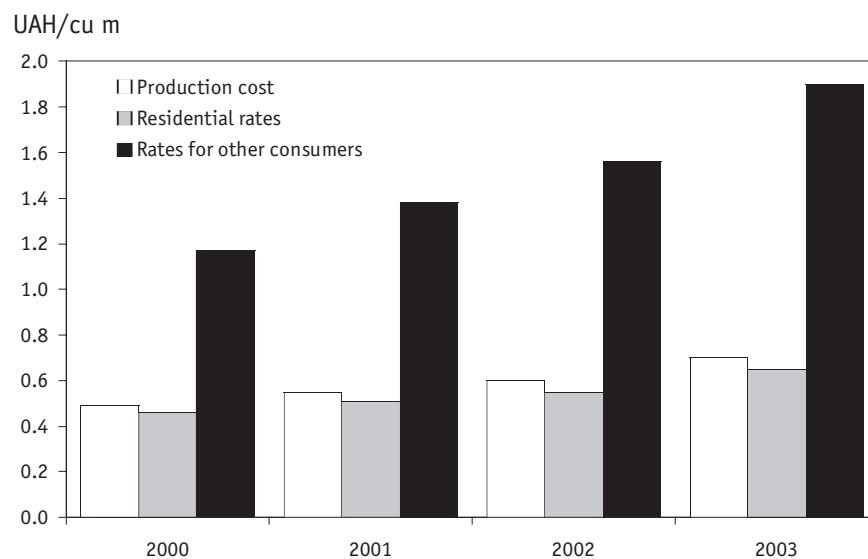
Problems with rate regulation hinder investment

All these problems distort incentives for attracting investment. Cutting back service costs and improving the financial standing of service providers, which also depend on effective investment policy, are complicated because of insufficient capital for introducing energy-efficient technologies. Re-equipment, optimized heating and water supply schemes for built-up areas, and the installation of water meters and regulators all require major capital investment.

Companies cannot finance re-equipment

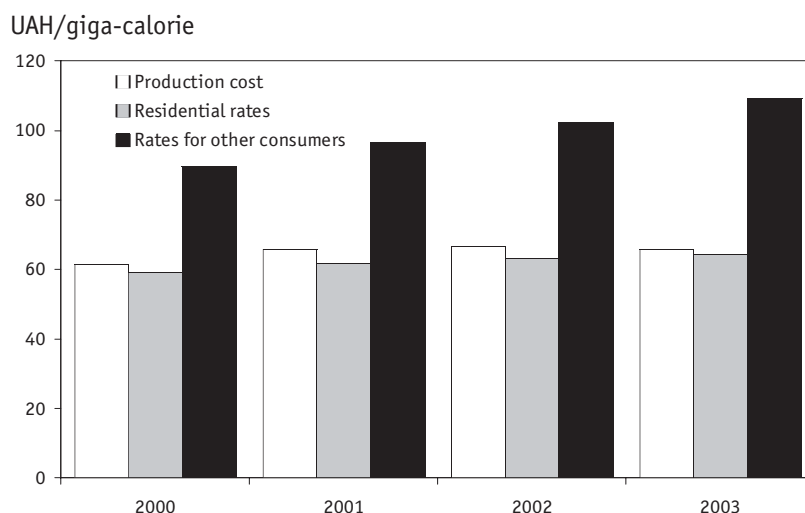
Companies in this sector cannot finance complex re-equipment programs using just their own resources. At the same time, partial and occasional re-equipment of separate facilities does not substantially lower the overall cost of services.

Figure 7. Production cost vs rates for water supply services



Source: State Residential Services Committee

Figure 8. Production cost and rate for heating services



Source: State Residential Services Committee

Goals, principles and approaches

Rate regulation is the key element to both reform and sustainable development in residential services markets that are dominated by natural monopolies, such as centralized water supply, heating and sewage.

State intervention is necessary when a market cannot achieve a better result. Rate regulation aims at lowering the prices for the final consumer set by monopolistic service providers and, at the same time, ensuring service quality through administrative and financial incentives.

In countries that are reforming their residential services sectors, the need for regulation, as a rule, precedes or accompanies the attraction of investment and/or changes in the principles of financing or privatizing companies in the sector and liberalizing the market. Rate regulation makes it possible to establish the rules for companies that change ownership form or financial approach. The lack of such regulation can affect the investment appeal of companies, as well as the principles of economic efficiency and social justice.

The point of regulating rates is to lower prices while ensuring quality of services

Principles

Internationally recognized principles of rate regulation³¹ that help achieve the desired goals include:

- **ECONOMIC EFFICIENCY:** resources are used in the most efficient way at the lowest possible social cost. Rates should encourage rational use of water and other resources by both consumers and the utility.
- **COST-RECOVERY:** rates produce revenue sufficient to meet the financial needs of the utility, including capital outlays.
- **FINANCIAL STABILITY:** rates minimize the risk of unexpected revenue fluctuations.

The desired goals can be reached by sticking to the principles of rate regulation

³¹ See OECD Report (2003) "Key Issues of Water Reform in the Water Sector in Eastern Europe, Caucasus and Central Asia (EECCA)."

- **FAIRNESS:** rates treat all consumers equally. Any system of subsidies for disadvantaged consumer groups should not interfere with economic incentives. Cross-subsidy should be used only as a last-resource tool.
- **UNIVERSAL ACCESS:** guaranteed access to services for all consumers, regardless of income.
- **SIMPLICITY AND UNDERSTANDABILITY:** rates have to avoid unnecessary complexity. Rates and rate-setting schemes should be clear to both utilities and consumers.

*Institutionalizing reform*³²

Reforms in rate regulation need to be consistent

Firstly, reforms need to be consistent in applying established principles. This requires three preparatory stages:

- Setting up an informational database, procedures for exchanging information and monitoring sector performance. The lack of information on the production and financial activity of a utility makes strategic planning and company development, cost control and the justification of higher rates, and quality control all impossible. Regulators, those subject to regulation, and third parties are all interested in having access to such information:
 - Utilities need it to identify processes that require improvement, to persuade their management and operators that changes are necessary, to develop investment plans, and to prepare projects.
 - Planning and regulating bodies at the central, regional and local levels need it to identify investment areas, and to set and revise rates.
 - Consumers need it to evaluate financial and service quality indicators among providers.
 - Potential investors and other partners need it to determine the operating efficiency and financial potential of a public utility.
 - International donors need it to identify priority areas and measures to provide investment support and technical assistance.
- Identifying and categorizing the real costs of a providing residential services:
 - By identifying targeted cost-recovery parameters and taking them into account in rate policy, utilities can begin to ensure total cost-recovery during the current period and provide a clear projection of future costs. For a provider, the costs should include operating costs, depreciation costs and the cost of attracting and servicing capital.
 - By categorizing costs into fixed and variable, the regulator can use a broader range of incentives with regard to rates.

Fixed costs are linked to management, the state of network plant, and to servicing and expanding the number of connections. Here, the goal of regulation is to lower fixed costs to their optimal level and to create incentives for additional cost reductions along while preventing any reduction in service range or restriction of access to services.

³² Ibid.

Variable costs include all costs related to the volumes of production, transportation and final delivery of services. As the cost of providing services is proportionate to the volume of consumption, a properly grounded rate policy can ensure consumption at a level that reflects the real needs of consumers while discouraging over-consumption.

- Introducing a system of separate tracking for different types of company activities and financial reporting. Differentiated financial reporting will make it easier for the regulatory body to calculate a rate of return for monopolistic operations, for example, separately for water supply and sewage services and for other (competitive) company activities. Calculating a rate of return, which can apply to any rate-setting method, should allow a potential investor to plan future cash flows and put together a realistic business plan.
- By controlling cost structures, the regulatory body has an important opportunity to track both cost items and production volumes. This can be done by:
 - introducing the practice of putting together company production plans and agreeing them with the city;
 - developing efficiency indicators as a mechanism for checking company performance;
 - using resource use norms to plan and evaluate actual consumption.

All costs are related to risks that service providers need to evaluate and report in the appropriate manner to the regulatory body. Cases of operating costs going over budget, changes in the cost of raw and other materials, shrinking demand—and, correspondingly, shrinking revenues—, force-majeur circumstances, and environmental pollution along with any associated penalties and costs to remove the consequences of the pollution all need to be carefully tracked.

*Methods*³³

Guided by basic regulatory principles, a regulator can use different methods depending on the body's powers and the economic and social efficacy of different approaches. Whatever method is established to regulate a natural monopoly, it should be done in a manner that is transparent and clear for all stakeholders and the regulator should oversee that it is adhered to.

1. COST-PLUS

This method of regulation is intended to allow the utility to recover costs and usually sets the rate of return on that basis.

The method's advantage is that it is relatively simple and transparent for all sides—regulator, provider and consumers alike. Using this method, the utility plans its costs on the historical principle or by considering its development plan and sets rates in line with a predetermined rate of return. As a rule, the regulatory body reviews the company's cost calculations (calculation base) and its justifications.

The advantage of cost-plus is that it is relatively simple and transparent...

The key drawback of the cost-plus method is that it does not provide incentives for companies to improve their efficiency. A company working under a cost of service regulation has incentives to overstate costs, over/underinvest in service infrastructure, and cross-subsidize consumers in different categories if reducing service levels is not permitted. In addition, such a utility also lacks objective incentives to

...but it lacks incentives to increase efficiency

³³ See World Bank Report "Water Sector Strategy" (2000).

reduce costs, since its profit is generally established as a fixed percentage of these costs.

Regulating the rate of return is more suitable for short-term regulation and does not allow the option to adjust rates due to, say, a rise in energy costs, since this will be taken into account during the next rate calculation cycle.

This approach creates a rate adjustment lag and a rise in accounts payable for the utility. The regulator can determine and change not only the rate of return, but also the calculation base—the cost of items eligible for reimbursement and for inclusion in the rate.

The negative aspects of the cost-plus approach can be partly mitigated through a performance contract, that is, contracts that pay for performance based on the expected savings (see below), although the operator will always have to work from a short-term perspective. Because of its reliability from the perspective of investors and its simplicity and transparency in terms of regulating the rate of return, this method is widely used in Canada, Hong Kong, Japan, the US, and many other countries, including all the NIS.

2. PRICE-CAP

Price-cap regulation involves establishing a rate (price) change formula for a long period. It is a more progressive formula than cost-plus, as it provides incentives for the utility to control costs and at the same time offers tools for improving efficiency. Price-cap regulation is applied over a longer period than cost-plus—usually 3–5 years. Countries that use this approach include Argentina, Chile, Malaysia, New Zealand, Peru, and the United Kingdom.

Price-caps encourage cost reduction

The key advantage of this method is that it provides incentives to raise operating efficiency. As the utility always knows the maximum price it can charge, the saving on costs during the term of the price-cap becomes part of the rate of return to the utility. The service provider has incentives to raise efficiency through resources that are freed up as a result of efficiencies during the relevant period.

Although stimulating cost controls that are desirable from a social perspective, this regulatory approach potentially has some negative effects. If regulation focuses exclusively on the upper price limit, the utility can respond by cutting costs on elements that directly affect the quality of the service—or it may be tempted to simply reduce the level of service.

In addition, this approach does not get around the problem of asymmetrical information. The regulator effectively needs to know the actual operation practices of the provider, the costs involved, and investment needs. A regulated utility could well respond with a strategy of providing information intended to mislead the regulator. In addition, the incentives for operational efficiency are substantially different at the beginning and at the end of the rate-cycle.

Establishing an adequate cap is a very difficult task for the regulator

Setting a cap at the appropriate level is exceptionally difficult for the regulator. If the cap is set at too low a level, it may pose a problem for investment and compensatory economies. The utility's efforts at cost control could result in the disappearance of many low-revenue services or in "skimming," when high-quality services are provided only to a specific group of well-off consumers.

If the regulatory body sets too many controls to neutralize the negative aspects of price-caps, it risks finding itself overloaded with operational indicators that require analysis and failing to actually track company performance.

3. PERFORMANCE CONTRACT

This method of rate regulation is an alternative to specialized regulatory institutions. The performance contract is a formal multi-year contract between a utility and a municipal government. The utility commits itself to targets for level and quality of service, management and operational efficiency, finances, and capitalization that can be monitored. The municipality commits itself to supporting the utility in reaching these goals by, for example, allowing timely rate increases or helping finance investments. Performance contracts are negotiated several years in advance, usually 3–5 years. They should be “live” documents, that is, while the underlying strategy conveyed in these contracts is not subject to change, periodic revisions of provisions in the contract may be necessary to reflect unforeseen developments. The contract normally includes quarterly, semi-annual or annual targets, as to:

- improving the effectiveness of the organization and training staff;
- introducing improved management and control systems;
- organizing better customer service;
- improving operational efficiency and use of resources;
- metering and lowering heat and water consumption through demand management;
- reducing water losses through better control;
- establishing cost targets for administration, maintenance and operation;
- making annual investment allocation, outlining an investment strategy and planning specific investments.

This method’s advantage is that integrated and flexible but clear criteria are established by which to evaluate the operator’s performance. It is fairer in characterizing the operator’s performance than simple control of price levels. Moreover, the performance contract can include legal mechanisms to make the operator fulfill obligations.

Recommendations

The performance contract seems to be the most appropriate option for regulating rates and prices through leases and concessions to the private sector as anticipated in Ukrainian legislation. After holding tenders for the right to provide services on the market, local governments can conclude contracts with an operator that will include identifying and tracking company performance indicators.

Cost-plus and price-caps can be used alongside. Indeed, elements of these methods can be reflected in performance contracts because any contract has to provide incentives for operators to reduce costs and raise operating efficiency.

An alternative option is the performance contract

The advantage is flexible but clear criteria to evaluate the operator’s performance

The performance contract is the most realistic option for residential services

Rate types and application

As a rule, optimal rates can be rather complicated in terms of their structure, for example, taking capitalization costs or a temporary cessation of services into account. Most rates can consist of one or more of these elements:³⁴

³⁴ See OECD Report (1999) “The Price of Water: Trends in OECD Countries.”

- **A FLAT CHARGE** is normally either equalized for each customer (e.g., within a given customer category or a particular geographical territory) or linked to some other customer feature (e.g., size of supply pipe or meter flow capacity, property value, number of consuming appliances, lot size, etc);
- **A CONNECTION CHARGE** is a one-time and normally up-front charge for connecting a customer to the public water or heat network or sewage systems. In the NIS, this type of charge is sometimes used for new buildings and newly connected customers. It is also applied when reconnecting disconnected customers in many developing countries. The economic efficiency criterion suggests that this charge should not be used to recover general system development costs.

If a metering system for residential services is in place, other possible elements can also be used:

- **A UNIT CHARGE**, which when multiplied by the volume of consumed service in a billing period, gives charge for that period. Economic efficiency and environmental criteria both suggest that this element should ideally recover all costs that vary between average and peak demand in the system in both the short- and long-run;
- **A VOLUME CHARGE** is defined by lower and (except for the limit) upper volumes of consumption at a particular billing level. Different unit rates are frequently attached to different volume levels. If rates rise or fall consistently as consumption grows, such schedules are referred to as incremental or decremental volume rates;
- **A MINIMUM CHARGE**, usually imposed to protect the utility's finances, which specifies that a certain minimum volume of the service will be paid for in each period regardless of whether that amount has been consumed.

The switch from standardized to metered water consumption needs to be balanced. Replacing the "consumption norm" system based on estimated per capita consumption—a leftover of the soviet approach that is widely used in the NIS—by an "actual consumption charge," when the water bill depends only on what the meter registers, has several drawbacks:

- 1) *if the unit rates are high, they can create incentive to reduce consumption below health and hygienic requirements;*
- 2) *if all flat rates are proportionally transformed into unit charge, the significant reduction of consumption that usually follows metering installation will not recover the fixed costs of the utility. The utility will be forced to increase rates to recover losses and the increase will likely reduce service consumption further;*
- 3) *networks have to be maintained regardless of consumption volumes. For example, some consumers use services on a seasonal basic, and as such will pay for services at the time of consumption. This means that providers will need to recover the costs of these seasonal consumers by redistributing them to other groups of consumers.*

CONSUMER PROTECTION

A particular feature of the residential services market is that relations are greatly interrelated, not only with consumer, but also with human rights. While basic human rights are protected by national legislation, international conventions, the Office of the Ombudsman and so on, the protection of residential services consumers requires additional legal standards, relations and institutions. This section will consider three key institutional approaches to consumer protection and evaluate their costs and benefits. A model of community and consumer associations is the most appropriate for Ukraine

Issues in consumer protection

The monopolistic nature of centralized water supply, heating and sewage services and the enormous dependence of the general population on these services make consumer protection an important issue. As a rule, executive institutions such as the State Technical Regulation and Consumer Policy Committee and its regional offices deal with broad protection issues. However, the specific nature of this market and the interrelations among its players make it imperative to set up a system to ensure consumer protection and supervise the adherence to constitutional rights related to essential services.

Monopolistic markets make it important to ensure consumer protection

The UN Guidelines on Consumer Protection³⁵ are the generally recognized international document in this area. The Guidelines identify key principles to build a national institutional and legal system. Several other international documents define the principle of protecting more specific interests of consumers. In particular the Aarhus Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters³⁶ sets out the procedure for protecting environmental interests of consumers and the society as a whole.

The protection of consumer rights is enshrined in Ukrainian legislation as a key principle for regulating natural monopolies.³⁷ When considering socially important issues, national commissions for regulating natural monopolies must hold sessions in the form of open hearings where representatives of consumer and community associations can participate.³⁸

Since good governance requirements include transparency, accountability and social responsibility, Ukrainian government institutions have lately started to set up community councils. These are universally recognized as a way to protect community interests. In terms of residential services, the community is for all intents and purposes equivalent to consumers.

³⁵ United Nations, Department of Economic and Social Affairs (DESA), 1985, UN Guidelines on Consumer Protection (as expanded in 1999), <http://www.un.org/esa/sustdev/sdissues/consumption/english.pdf>.

³⁶ Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters, Aarhus, Denmark, 25 June 1998, <http://www.uncece.org/env/pp/documents/cep43e.pdf>.

³⁷ See Art. 9 (1) of the 20 April 2000 Law “On natural monopolies.”

³⁸ Ibid.

There is virtually no system for protecting residential services consumers in Ukraine

In practice, there really is no system for protecting consumers of centralized water supply, heating and sewage services today. Initiatives are sporadic and frequently these are political actions aimed more at a quick increase of voter support than at real consumer protection. In short, the sector needs an effective system of institutions and relations to ensure systemic, continuous and effective consumer protection.

Options for consumer protection institutions

There are three main options for consumer protection

There are three main options for organizing institutions to protect consumers of residential services:

- 1) specialized departments under the regulator;
- 2) independent organizations that are partners of the regulator on the residential services market;
- 3) community organizations and consumer associations.

Moreover, these options are not mutually exclusive: two or more types of organizations can operate at the same time. Where this is the case, such organizations should encourage cooperation. For example, a department within the regulatory body can have a community council, which includes representatives of the community and ordinary residents.

Independence and real impact on decisions are the key requirements

The key requirements of consumer protection institutions are independence, competence, a real impact on decisions, and representation of all consumers without any exceptions, especially vulnerable population groups.

The main activities of such institutions should be:

- to review and resolve consumer complaints against utilities;
- to evaluate utility responses to complaints;
- to debate policy and rate changes;
- to evaluate relevant government decisions;
- to evaluate the performance of service providers;
- to develop and review contracts between consumers and service providers;
- to continuously monitor service standards;
- to monitor how utilities handle the issues like unpaid bills and meter installations;
- to monitor how utilities introduce special rates for specific consumer groups;
- to provide incentives for more efficient use of resources by both providers and consumers;
- to provide consumer-oriented feedback on financial issues (capital investment, profits and dividends), and on company plans for corporate restructuring, mergers and acquisitions.

Specialized departments within local government bodies

The term “residential services” indicates that local government bodies are primarily responsible for providing these services. And local support for local government largely depends on service quality. Because it wants to maintain its own legitimacy and gain public support, local government has a vested interest in setting up specialized departments to protect consumers and facilitate the efforts of organizations pursuing similar goals.

As service providers are mostly public utilities and, thus, are subordinate to local government bodies, it is important to avoid possible conflicts of interest between the goals of utility management and the protection of consumer rights and interests.

Advisory councils³⁹ are often established under local governments for the most legitimate representation of consumer interests and minimization of any conflicts of interest. These bodies help citizens have a direct impact on the decision-making process in local government.

A high motivation to protect consumer interests is the key advantage of such a body, as it ensures, in return, political support for a local government body in the community. However, such a body is also likely to work on an irregular basis related to political cycles. In addition, close relations between this body and the municipality, especially if service providers are public utilities and managed by local government, create the potential for a conflict of interests.

Independent partners of the regulator

The national system has an interesting approach to setting up an independent consumer protection body based on the sector’s regulator. Although this is a “top-down” approach to the organization of a consumer protection system, an independent body can have a broad network of highly decentralized territorial units, which brings it closer to the consumer.

WaterVoice,⁴⁰ a British partner organization of OFWAT, the water supply and sewage services regulator, is a good example of such a body. This organization has 10 regional committees in England and Wales.⁴¹ The OFWAT Director General is responsible for appointing committee members⁴² after consulting at least with the chair of a relevant committee and an independent expert. The chairs of regional committees are members of the consumer council that represents consumer interests at the national and European levels.

Actually, this organization is an intermediary between consumers and other stakeholders. It helps eliminate problems during the decision-making process, especially by ensuring information exchange among market players.

³⁹ For example, such a council was set up under a public utility in Anaheim, California. It consists of 7 community representatives. Similar councils have been established in many Ukrainian cities, such as Komsomolsk and Lutsk.

⁴⁰ To learn more about WaterVoice activities, check their site at: http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/navigation_watervoice_homepage.

⁴¹ The British system of regulating water supply and sewage services is not unified. For example, Scotland differs substantially from England and Wales.

⁴² A committee member cannot be an employee of a water supply and sewage utility and, in some cases, not even the employee of its supplier or contractor because of the need to avoid a potential conflict of interests. Committee members sit on a voluntary basis, that is, they do not receive a salary, but their related expenses, for example, fare and accommodation, can be compensated.

The key advantage of local government is its proximity to consumer interests

Lack of conflict of interests is one advantage of a partner organization

The lack of a conflict of interests between management and consumer protection is a positive feature of this option. It has to be mentioned that this also requires real independence on the part of the regulator. Still, it is often difficult to provide incentives for active consumer protection. Typically, the regulator pays more attention to technical issues such as network connections, licensing, and so on, than to civil rights. So this option needs a clear identification of rights, obligations and interrelations among the regulator, the consumer protection institution and all other stakeholders that will ensure effective and efficient consumer protection.

Community organizations and consumer associations

A “bottom-up” approach is a special feature of the third option

Unlike the two previous options for consumer protection, community organizations and consumer associations use the “bottom-up” approach. These are organized by consumers and bring together the capacities of community members or specific consumer groups for more effective and efficient protection of their rights and interests.⁴³

If such civil society institutions are highly organized and enjoy broad public support, local government bodies, public utilities and regulators have to take their position into account. Community organizations are beneficial to their communities in terms of facilitating the submission of complaints, requests for information (explanations, inquiries about environmental impact, etc.) of regulatory bodies and service providers, the filing of lawsuits, and so on. Associations of specific groups of residential services consumers, such as large industrial companies, can effectively protect their rights. A clearer and more transparent process of expressing different opinions, agreeing them and adopting final regulatory decisions is an argument in favor of several organizations for protecting the rights of various consumer groups.

Legitimacy and effectiveness are the two advantages of community and consumer organizations

The advantages of community organizations and consumer associations are proximity to the consumer and a correspondingly high level of legitimacy and effectiveness. However, these institutions quite often lack technical, economic and other knowledge, so it is very important to develop their capacities through training programs and other measures. Community organizations also need to have real leverage to affect the situation in the sector.

Recommendations

Community and consumer organizations are most appropriate for Ukraine

In our opinion, the third option—community organizations and consumer associations—is the most appropriate option for protecting consumer rights and interests in Ukraine.

Ukraine does not have a long history of market institutions during which time it could have developed a strong tradition of protecting consumer rights. So the establishment of consumer protection organizations using a “top-down” approach faces the risk of creating an additional bureaucratic structure with numerous potential conflicts of interests.

The main advantages of community associations are that they:

- directly represent the interests of the average consumer, that is, the society;
- are not part of the executive and, therefore, will have no political or commercial conflicts of interests—such as giving preference to state-owned companies—inherent to emerging markets;

⁴³ For example, Florida Utility Watch, Inc., an independent non-profit organization, protects consumer interests in Florida (<http://www.floridautilitywatch.com/>).

- already have a legal basis to work on the market.⁴⁴

Setting up and developing such organizations is usually on the basis of civic initiatives that are part and parcel of building civil society, a process that is currently taking place in Ukraine. However, such initiatives need support from the government, donors and market players to inform the public and increase the institutional capacities of consumer associations.

⁴⁴ The Law “On natural monopolies” stipulates: “Consumer associations shall carry out public oversight of natural monopolies according to procedures established by law. Regulators of natural monopolies shall help consumer associations carry out public oversight of natural monopolies.”

APPENDIX I:

CONSULTATIONS AND DEBATES.

RESULTS OF ROUNDTABLES

A series of public debates consisting of two roundtables was held to help prepare this policy paper. The aim of these debates was to identify the positions of different stakeholders on problems hindering regulatory reform in the residential services sector, analyze different policy options, and produce recommendations.

Roundtable №1: Regulatory Policy in Ukraine's Residential Services Sector

On 25 June 2004, ICPS hosted the first roundtable on “Regulatory Policy in Ukraine's Residential Services Sector.” The purpose of the roundtable was to discuss the decentralization of regulatory powers, cooperation among local government and executive bodies, and the coordination of regulatory functions assigned to relevant ministries and departments.

The roundtable started with presentations by a representative of the Ministry of Economy and European Integration (MEEI) and an expert from the International Centre for Policy Studies.

Participants discussed:

1. What government policy priorities should be during the establishment of a regulatory system in the sector.
2. What hampers the implementation of regulatory policy.
3. What the options are for setting up a regulatory system.

Stakeholders whose representatives took part in the debate included:⁴⁵

- the State Residential Services Committee;
- MEEI;
- the Ministry of Finance;
- the Kyiv City Administration;
- PADCO, a US consultancy / Local Development Institute;
- the Institute for Reforms.

Key positions

Specialists in residential services said that the main obstacle to getting this sector back on track was the lack of a solid government strategy that had been agreed with all stakeholders and had a goal of ensuring a balance between the interests of

⁴⁵ The National Electricity Regulatory Commission submitted its proposals in writing.

providers and consumers of residential services.

According to most participants in the discussion, regulatory activity in the residential services sector has largely been unsuccessful so far. They felt that the government had failed to achieve one of the key goals of regulation, balancing the interests of different stakeholders, because of frequent politicization of the touchy issue of affordability.

The lack of clarity around reform priorities has resulted in chaotic legislative activity. In paying excessive attention to specific points of regulatory policy, particularly the issue of rates, the Government has neglected to look for solutions to such problems as defining universal quality standards for residential services, attracting private sector investors, and handling state procurements. Unsatisfactory public relations with regard to new initiatives and changes to legislation have often led to low awareness at the local government level about transformations in the sector and their practical implications.⁴⁶

Experts in the residential services sector said that most of Ukraine's reform-oriented programs were faced with the problem of limited government resources, whereas this sector needs particularly large investments into infrastructure. Moreover, dilatory reforms are simply increasing the mutual distrust among the key market participants: providers, consumers and regulators. The consumer expects to be provided with high-quality services, but outdated infrastructure makes it impossible for the provider to do so, while regulators cannot raise rates to a level that would recover the necessary costs of upgrading.

Proposals

The participants agreed with the formulation that the main aim of regulatory policy in residential services is to balance the interests of providers and consumers, and the role of the state is to support laws and establish mechanisms for ensuring and overseeing their implementation.

The participants listed a number of priority regulatory policy issues that need to be determined:

- what is being regulated and what kind of regulatory instruments should be applied;
- how the set of regulatory powers should be divided among local and central governments;
- what procedures should be entrenched for regulatory bodies to exercise their powers.

When it came to centralizing or de-centralizing regulation in the sector, the majority of participants agreed that moderate de-centralization was acceptable. Some participants also emphasized the necessity to separate the functions of operating and regulating the sector's enterprises. Yet all admitted that determining the ultimate division of regulatory functions between the center and the regions was a challenge.

Participants considered the need to develop a grounded regulatory approach for the residential services sector—and one which would consider the positions of all stakeholders and the sector's specific characteristics—a top priority. The residen-

⁴⁶ Most participants welcomed the adoption in the Verkhovna Rada of a Law "On a statewide program for reforming and developing the residential services sector for 2004–2010" and a Law "On residential services." Yet they also pointed out that these laws face serious risks because there is not enough of a relevant legislative base in place, including regulations and standards, to support them.

tial services sector includes a long list of industries, and regulatory policy in each of them needs to be different, they said. In their opinion, reforms would go faster up if a public dialog were established among providers, consumers and state regulators.

Roundtable №2: Conceptual Principles for Regulating Natural Monopolies in the Residential Services Sector

On 3 December 2004, ICPS hosted the second roundtable on “Conceptual Principles of Regulating Natural Monopolies in the Residential Services Sector.” The purpose of the roundtable was to identify the positions of different stakeholder and to put together policy recommendations.

The roundtable started with presentations by a representative of the State Residential Services Committee and an expert from the International Centre for Policy Studies.

Participants discussed:

1. What the goals are for improving the system of state management and regulation of natural monopolies in the sector.
2. What key problems need to be resolved.
3. What the options are for improving the system of state regulation in the sector. What the costs and benefits of these options are.

Some of the comments, proposals and remarks were included in a draft concept called “State Regulation of Natural Monopolies in the Residential Services Sector.”

Stakeholders whose representatives took part in the debate included:

- the State Residential Services Committee;
- the Anti-Monopoly Committee;
- the National Electricity Regulatory Commission;
- the Kyiv City Administration;
- PADCO, a US consultancy / Local Development Institute;
- the Institute for Advanced Professional Training;
- the Economic R&D Institute under MEEI;
- the Academy of Municipal Government;
- AEK KyivEnergо, a joint stock energy company;
- the Institute of General Power Engineering under the National Academy of Sciences.

Key positions of participants

According to participants, achieving the key regulatory goal of balancing the interests of consumers and providers of residential services is hindered by:

- unclear distribution of regulatory powers between local government and the State Residential Services Committee;
- insufficient institutional capacity in the country to regulate natural monopolies due to the lack of specialists, methods literature and resources. As a result, regulation is implemented primarily on the basis of socialist economic principles;
- underfinanced support for quality standards in providing residential services, which are supposed to be universally accessible, and ineffective oversight of how they are implemented;
- lack of legislation introducing regulation in centralized heat supply and the need to separate competitive activities from monopolistic ones;
- unclear subordination among companies located on the territories of different territorial and administrative units and those that are leased.

Proposals

Participants did not reach a final agreement on the optimal regulatory system in the sector and proposed several options.

The first reform option is to switch from the current regulatory practice, rate regulation, to developing and concluding long-term agreements between service providers and local government bodies.

Participants in the debate identified key areas for implementing the second option, centralized state regulation:

1. Assign the National Electricity Regulatory Commission regulatory functions:
 - with respect to all natural monopolies in the residential services sector; or
 - only in centralized heating.
2. Set up specialized national commissions in the water supply and sewage sector and centralizing district heating.

Experts and Government representatives made several important suggestions to improve the current regulatory system:

1. The responsibilities of central executive bodies fulfilling regulatory functions should include identifying rules for setting rates, norms for leakage and line losses, and specific energy consumption norms. Local government bodies should approve the final level of rates for residential services within price-caps established by the center. If rates turn out to be below the level of production cost that can ensure the affordability of the services, the local government should have an obligation to compensate this difference, as foreseen in new legislation.
2. Companies providing services on the territory of several communities should be regulated by the central or local government body whose territory uses more than 80% of the service volumes delivered.

3. To protect the interests of consumers and the environment: (1) associations of residential services consumers should be set up that can have impact on regulatory decisions and (2) environmental institutions should be more actively involved in regulation.

According to participants, the “State Regulation of Natural Monopolies in the Residential Services Sector” concept should reflect international experience, the actual situation in Ukraine today, and propositions for amending existing legislation. The interests of different stakeholders need to be clearly identified and taken into account.

APPENDIX II: CONSULTATIONS AND DEBATES. RESULTS FROM THE REGIONS

The “Policy Development Program: Regulatory Reform in Ukraine’s Communal Services Sector” project included visits to three Ukrainian cities that were carrying out pilot projects to reform this sector. The purpose of these visits was to study reform know-how and to consult with representatives of local governments on improving state regulation of natural monopolies.

When preparing the policy paper, ICPS specialists visited eastern and western Ukraine: Komsomolsk in Poltava oblast and Lutsk in Volyn oblast.

Results from Komsomolsk

During the first regional visit, ICPS representatives participated in a workshop called “The Experience of Successful Management and Innovative Approaches to the Residential Services Sector,” which took place in Komsomolsk on 14–15 June 2004. The goal of the workshop was to disseminate information on the results of regional pilot projects to reform the sector. The workshop was supported by USAID, the Education Support Academy, the Association of Ukrainian Cities and Communities, and the Regional Business Support Center. The event was attended by representatives of local government and public utilities from 14 Ukrainian cities, the State Residential Services Committee, and NGOs.

The presentations and consultations at the workshop allowed ICPS representatives to conclude:

1. Introducing a centralized model of state regulation in the residential services sector, which is in effect in the power and communications sector in Ukraine, is complicated due to the local nature of natural monopolies. A more decentralized regulatory policy in the sector is justified because of substantial gaps in social and economic development across the cities and regions. At the same time, there is a problem of agreeing and coordinating local initiatives to reform the residential services sector with central government bodies.
2. This sector has a problem with unclear assignation of functions and powers to bodies that manage and regulate services. Firstly, under certain circumstances, both local state administrations and local government bodies can set rates for residential services. Secondly, local government bodies combine management and regulation of assets, placing them in a conflict of interests situation when short-term political expediencies do not match long-term economic imperatives.
3. Current problems and achievements in reforming the sector point to the importance of establishing an ongoing public dialog. Setting up community councils in cities implementing pilot projects has had a positive impact on the results of local initiatives.
4. Reform-oriented initiatives are often hampered, facing the lack of legislation or a flawed legal base for concluding agreements, distributing the powers of residential service market players, and so on. This has to do with dividing responsibility for servicing internal building networks and installing and servicing meters.

Participants discussed important aspects of reforms in the sector with representatives of service providers, the Government, and consumer associations, and independent experts. ICPS specialists used the information and training materials in preparing this policy paper.

Results from Lutsk

On 19 October 2004, ICPS economists visited Lutsk to consult with representatives of municipal government and residential service providers on options for drafting regulatory policy in Ukraine's residential services sector. The participants included:

- the Deputy Mayor of Lutsk;
- the Chair of the Residential Services Department under the Lutsk City Executive Committee;
- the Director of LutskTeplo, the municipal heating plant;
- the Head Engineer of LutskVodoKanal, the municipal waterworks;
- ICPS economists.

The consultations addressed five key problems raised by the policy paper.

Options for introducing state regulation

Participants did not support the option of setting up a new central or regional regulatory body for natural monopolies because it might increase administrative pressure on service providers. According to participants, the current regulatory impact of central government bodies—the Anti-Monopoly Committee, the State Price Oversight Inspection and the State Tax Administration—in the residential services sector is already excessive. Representatives of local government and public utilities also expressed doubts that this negative pressure would be reduced with the introduction of a special regulatory body with rate-setting functions.

According to participants, the advantage of decentralized regulation—currently, the Lutsk municipal government fulfills most regulatory functions in the sector—is that local government is better informed about the regulated utility than a possible regulator in Kyiv or at the oblast level. However, unclear division of regulatory powers between local councils and oblast state administrations is impeding the effective implementation of this option.

The Lutsk municipal government also thinks that this option can be implemented by regional and village councils, despite a possible lack of qualified specialists. The problem of high-quality regulation by village and regional councils can be resolved by involving outside experts: specialists from municipal residential services departments, oblast administrations or consultancies.

According to participants, the central executive body in the sector, the State Residential Services Committee, ought to develop government policy and provide methodological support to local government bodies to help them regulate the sector. A single method for calculating prices and rates throughout Ukraine would greatly facilitate and improve the rate-setting process.

Rate policy

The public utilities whose representatives were present at the meeting were all profitable: when companies begin to be unprofitable, rates are revised upward.

However, so far, rates have been covering only operating costs: as a rule, they have not included the investment component.

Participants mentioned that state regulation of salaries at service providers and energy costs, which are a key rate component, restricts municipal rate policy potential. Rates for residential services in Lutsk are revised once every few years: the current rate for centralized heating has been in effect for more than four years. Rapid gas and electricity price hikes have led to more frequent rate revisions in those sectors, but this upsets consumers.

Social policy

Lutsk confirmed that there was a problem with recovering the costs of providing services to privileged consumer groups. Unfulfilled commitments from the central government to the city of Lutsk stand at several million hryvnias and make it difficult for service providers to pay their taxes.

At the same time, participants noted that a recent Government decision to cancel arrears in payments for residential services in exchange for compensating individual residents for their depreciated deposits with Oshchadny Bank was unfair to providers and consumers who were not deadbeats and would only worsen payment discipline. The current Government practice of allocating subsidies to some cities where the residential services sector is unsatisfactory also demotivates those cities that have successfully reformed the sector and avoided a crisis.

Participants mentioned targeted cash assistance and the institution of social inspectors among the options for improving the social net for impoverished consumers. The Lutsk government is introducing additional local privileges for some groups of consumers, in particular for the blind.

Consumer protection

Active public involvement in decision-making has become a guarantee of successful residential services reform in this city. Setting up community councils made it possible to adopt effective socially sensitive decisions on, for example, rate revision. Lutsk community organizations can be granted the right to determine the level of rates for a building, for instance, while the government oversees the provision of a minimally necessary quality of services.

Financial policy

Lutsk plans to tackle the problem of capital investment and financing unforeseen costs by setting up a targeted fund. A municipal bond issue is technically possible, but is not expected at the moment.

In the near future, the government does not plan to transfer water supply or heating companies into private sector management or ownership. According to participants, the option of involving the private sector makes sense only if the sector is facing a crisis, as there is a high risk that business will not be interested in making long-term investment into a utility. At the same time, the private sector is welcome to take over planting greenery, collecting garbage and maintaining buildings and open areas.

Unlike transport, education and healthcare, the State Budget does not include a separate item on the residential services market. This means that funding is determined on a “whatever’s left” basis. To resolve the problem of subsidizing the sector, the Lutsk government has proposed delegating the power to collect VAT to municipal governments and leave a portion of the tax with the city.