

## **Infrastructure Monitoring for Ukraine (IMU)**

**No. 3/2002**

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## Summary

This third issue on Infrastructure Monitoring for Ukraine (IMU) gives an overview of the progress of reforms in the infrastructure sector. The major focus of our attention is on the government's restructuring policies and on the regulation of major infrastructure industries. Simultaneously with this review of the reform developments in the infrastructure industries we present their analysis and evaluation. The methodology of evaluation was presented in the first issue of the IMU. In the second issue of the IMU the methodology was slightly amended to provide for cross-industry compatibility.

The **Telecommunications** sector experienced a slight deterioration in the grade from 2.24 to 2.22 due to worsening transparency of its regulation. The campaign, aimed at elimination of international traffic fraud by private operators, initiated by the regulatory body (SCCI) and supported by the state-owned Ukrtelecom has resulted in multiple and often unilateral disconnections of private operators. The anticipated privatisation of Ukrtelecom influences not only its current corporate management approach and its investment decisions, but also the sector's development pattern, like licensing restrictions on international and intercity telephone services. Although a privileged subscription for Ukrtelecom shares was completed with moderate success and the Cabinet of Ministers has already approved the terms of tender for its privatisation, the date is still unknown.

For the **Railway** industry the grade has increased from 1.49 to 1.54. This is mainly due to improvements in the assets management of Ukrainian Railways. While cutting costs, Ukrzaliznytsia increased its investment activity. However, Ukrainian Railways face severe criticism for investing outside the industry, while the quality of its own service remains poor. Management of Ukrzaliznytsia explains this with its intention to increase non-tariff revenues. This is a solution, which Ukrzaliznytsia needs to employ in a situation where loss-making regulated tariffs cannot be increased, i.e. passenger transportation has to be subsidized by other internally generated resources. The problems faced by Ukrainian Railways stem from very poor tariff regulation for rail transportation (cross-subsidization and pricing below cost).

The **Roads** industry grade remained constant at 2.19. The only progress was recorded in the de jure separation of the roads regulation from management; so far it has only helped to increase the transparency of investment decision-making. However, de facto the regulatory body still remains the principal managing body. The problem of insufficient budgetary financing has still not been overcome; no measures were taken to establish a new road fund, or to find ways to develop public-private partnerships. Both these problems are related to inadequate Ukrainian legislation, which in particular constrains private investor participation in roads rehabilitation.

The reforms in the **Power** industry were suspended between December 2001 and June 2002; the grade remained constant at 2.51. The completion of parliamentary elections in April 2002 also has not had a substantial impact on this industry restructuring yet. Privatisation of the regional power distribution companies (oblenergos) and the power generating companies according to the privatisation plan for 2002 was postponed for an indefinite period. The NERC tried to solve the problems of the financial sustainability of the power generating companies based on fossil fuel plants at the expense of the nuclear power company "Energoatom". Payments to these companies from a special



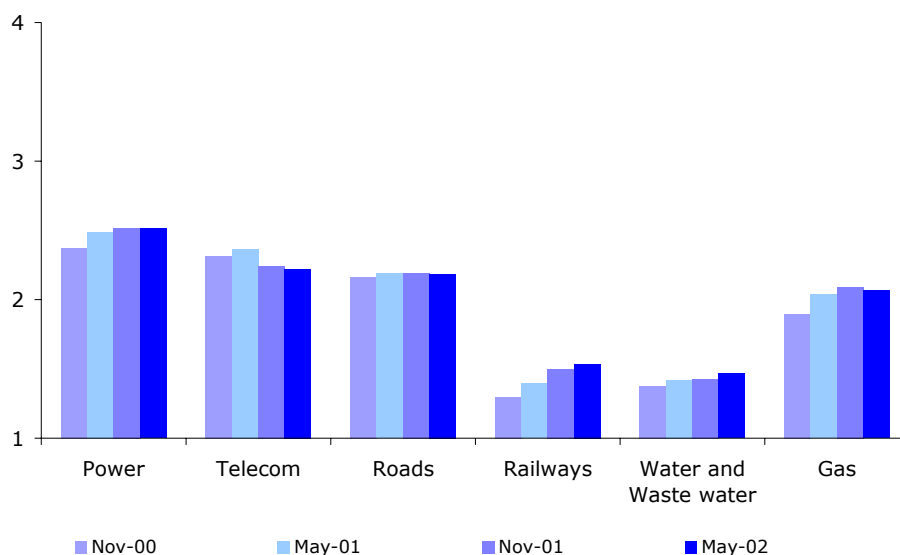
clearing account were in substantial disproportion to the amount of electricity supplied by them to the wholesale electricity market.

The grade for the **Gas** industry has declined from 2.09 to 2.06 due to deteriorating collection ratios from the final customers, and the absence of any substantial progress in other areas. The level of tax payments by NAK Naftogaz Ukrayiny for transit services was only about 65% of the budgeted amount for the first quarter of 2002, and as a consequence the subsidies for other utilities companies were not paid in full. The absence of cost reflecting tariffs, the lack of a legislative framework for market regulation and competition enforcement as well as government interference in NAK Naftogaz Ukrayiny's activities remain major problems for the sector.

The grade for the **Water and Wastewater** industry has increased from 1.42 to 1.47. Despite the urgent necessity for industry restructuring only a few cases of improvement of the corporate governance were noted. These are mainly related to rehabilitation projects financed by international financial organisations, in particular in Zaporizhia and in Lviv. The government adopted a decree "On the reform and development of the utility sector in 2002-2005 and until 2010" aimed at market restructuring of the utility sector. Also, according to a Presidential decree the State Committee of Ukraine on Housing Policy was made responsible to implement the state's policy concerning this industry. It was subordinated to the Cabinet of Ministers. However, the legislative framework for its performance has not been adopted yet. Low payment rates, cross-subsidisation of the residential sector by industry, and inappropriate metering of consumption remain the major problems of this sector.

### Graph 1

IERPC's infrastructure indicators for Ukraine



Source: Own estimations

Note: The indicators in this graph are presented without rounding, unlike in the table summarizing the indicators. This allows observing slight changes.



## 1 Introduction

Infrastructure liberalisation is a painful issue both for developed and developing countries. Aside from “conventional” problems of private sector introduction into this sector and efficient pricing, at least three transition economy infrastructure problems stand out. Firstly, strategic investment decisions and institutional frameworks were developed without reference to economic efficiency. Pricing below costs, inefficient operational management and poor transparency are just some of the problems here. Secondly, the overwhelming domination of state ownership has favoured administrative controls over a regulatory environment of the enterprises. The resulting pervasive institutional structures have become self-reinforcing or locked-in in Ukraine. Thirdly, the paternalistic nature of the social security system modifies infrastructure markets to make them a channel through which social transfers are directed toward individuals. Thus, infrastructure restructuring becomes an extremely important issue that requires reliable and permanent monitoring, which must look at the whole picture instead of just some fragmentary pieces. Last but not least, new regulatory models need to be introduced in Ukraine, establishing competition in formerly monopolistic sectors.

This third semi-annual issue of the IMU presents information on restructuring of six infrastructure sectors of the Ukrainian economy in a standardised manner, which allows for cross-industry comparison. When developing the evaluation methodology the Institute for Economic Research and Policy Consulting followed the EBRD’s approach<sup>1</sup>. Monitored indicators are qualitative and fall into three broad categories: (1) commercialisation, (2) tariff reform, and (3) regulatory and institutional development. Twenty-one indicators allow for economic and policy-making analysis at different aggregation levels. The indicators are constructed in a way that represents the situation concerning reforms in each sector at corresponding moments of time. Brief descriptions of the reform progress in each infrastructures sector supplement the numerical evaluation and provide a broader view of the situation within the different sectors. Current methodology assures time continuity and cross-industry comparability of the indicators.

In this issue we present short general reviews of government policies and of the development of reforms in the infrastructure industries. In the appendices we summarise our evaluations in tabular form and provide methodological explanations and detailed comments for each indicator.

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<sup>1</sup> For more details see IMU #1, Working Paper No. 8, June 2001



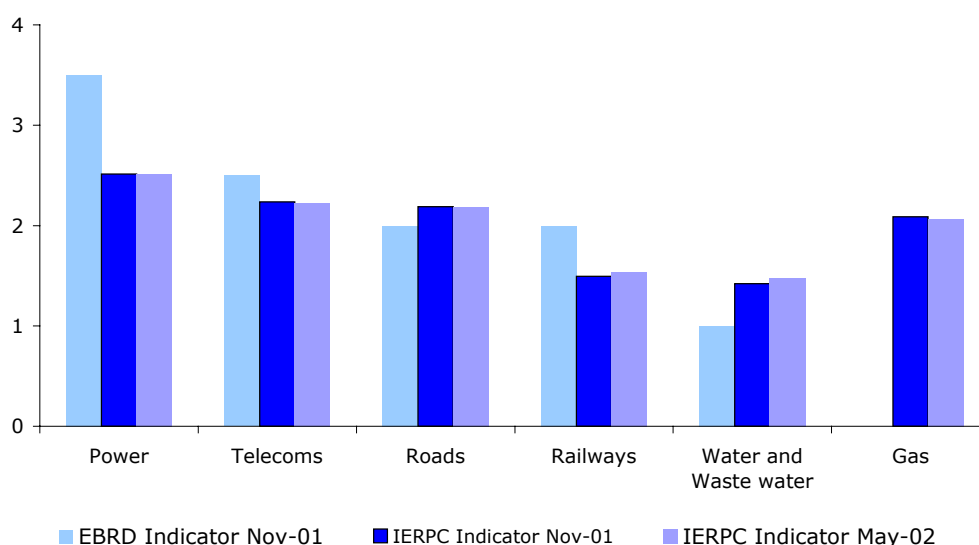
## 2 Ukrainian infrastructure policies, November 2001 – May 2002

The common denominator in the infrastructure sector is stagnation of the reform processes. In the Graph 1 we even noticed a slight regression in industries, which used to be quick reformers. In telecommunications this is explained by non-transparent measures of the monopolistic state operator recently taken in the field of interconnections, which were very close to a monopolistic abuse of power. The slight decline in the gas industry is caused by decreasing monetary payments that shows a non-sustainability of improvements made in previous periods. The slight improvements in the railway and water supply industries are related to improving assets management and increasing public-private partnership respectively. In general, the reforms in the infrastructure industry have lost their dynamism, while unresolved problems continue to accumulate. Policies establishing tariffs, which do not recover cost, contribute to rapid infrastructure depreciation and put the sustainability of infrastructure services supply at risk.

The EBRD indicators for telecommunications, roads and railways remained stable in 2001, while the power industry indicator was upgraded and the water industry indicator was downgraded by half a point<sup>2</sup>. This has increased the gap between the latter EBRD and IERPC indicators (see Graph 2). Among all industries, only the gap in the railways industry indicators is slowly contracting as management of that industry improves.

**Graph 2**

Infrastructure indicators for Ukraine



Source: EBRD, Transition report, 2000 and 2001; own estimations

Notwithstanding the reform slow down, we noticed some renewed interest in the development of measures to reform the public utilities sector by the

<sup>2</sup> See IMU No.2 for comments on the differences of approach.



Ukrainian government. Firstly, the Cabinet of Ministers has approved the program "On the reform and development of the utility sector in 2002-2005 and until 2010". This program provides for the creation of conditions to attract private investment, to reduce costs and to raise the quality of the services through reorganisation of the sector. Secondly, the Cabinet of Ministers has adopted the "Strategy of Substitution of Privileges for Income Subsidies in Ukraine". This strategy consists of three stages<sup>3</sup>. The first stage, up to 2004, concerns reforming the public utilities regulations, including subsidization. The second stage, 2004-2005, envisages reforming the subsidisations in the transportation sector. During the third stage, 2005-2006, the social security system reform is intended to be finalised.

At the present time the government is developing public utility regulations, in particular tariff setting and auditing procedures. One of the disputed issues is whether central government bodies should regulate public utilities. There is opposition to such an arrangement. However, in countries with long traditions of public utility regulations there is a central regulatory body in place. It provides methodological support for utilities management and ensures coordination of regulatory policy for different utilities suppliers, for instance, electricity and water suppliers.

An important event in the transportation sector was the appointment of Hryhoriy Kyrpa as Minister of Transportation. Mr. Kyrpa is also the Head of the State Railways Administration. This appointment has raised hopes for improvement in the management of all transport industries, similar to what was successfully achieved in the railway industry. An expansion of the freight transit capability was established as a major intermediate term target of the Ministry. In particular it is planned to increase the share of national freight carriers for freight transit throughout the territory of Ukraine, and plans have been made to improve the transportation infrastructure<sup>4</sup>. Special attention will be paid to new capital investment in the transport sector<sup>5</sup>, attempting to use non-public funds. Leasing is proposed as a possible instrument for attracting investment to the sector. Hryhoriy Kyrpa intends to stabilise the transportation system within one year and hopes to modernize the system by placing orders with Ukrainian enterprises. The Minister also intends to stimulate the cooperation among all modes of transportation, which of course requires tariff policy coordination.

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<sup>3</sup> At this time 31% of the Ukrainian population is eligible for privileges, while almost 50% of them are economically active. Financing of these privileges accounts for UAH 22-23 bn a year in Ukraine, while there still remains a UAH 12-13 bn gap between legislated and actually financed privileges. Most privileges are in public utilities, housing, fuel, transportation and telecommunications.

<sup>4</sup> Only 10% of the cargo transported within the Ukrainian territory is carried by domestic companies, 92% of the products produced by the mining and metallurgical industries in Ukraine are exported by foreign carriers.

<sup>5</sup> Nearly 53% of the assets in the transport sector are fully depreciated, in the railways sector it is 58%, in road transportation up to 80%.



## 2.1 Telecommunications

### 2.1.1 Reforms, December 2001 - May 2002

The telecommunications sector reforms, which were suspended during the second part of 2001, have not been seriously restarted to date, which to some extent can be attributed to the recent Parliamentary elections. Several regulations concerning licensing and tariffs for local telephone service consumers are of marginal importance and do not address any major problems in the sector's regulatory environment. Also, it is planned to legalize a de facto moratorium on licensing international and intercity telephone services prior to the Ukrtelecom privatisation. Despite several applications from companies like Optima, UMC, UkrSat, Farlep, Velton Telecom, etc. the licensing was not resumed in order to preserve the investment attractiveness of the state company to potential participants in the privatisation.

Although Ukrtelecom issues options granting local telephone operators the right to connect to its network<sup>6</sup>, the legal basis for interconnections as well as an independent control function still remain unresolved issues.

Recent developments in the sector present some evidence that Ukrtelecom abuses its monopoly power. Insufficient regulatory rules concerning interconnection resulted in multiple and suspicious disconnections of competitors in the local fixed line telephone segment under the pretence of an anti-fraud campaign. The disconnection procedures are not clearly defined according to judiciary norms, are mostly non-transparent and often performed unilaterally by Ukrtelecom. There are also some indications that Ukrtelecom uses discriminatory pricing for interconnections<sup>7</sup>.

The strong links existing between Ukrtelecom and SCCI, enhanced by the committee's management of the state corporate rights in the company, and by the practice of selecting committee chairmen from the ranks of Ukrtelecom managers, can be seen as unfair competitive advantages of Ukrtelecom vis-à-vis other market agents. The most striking example of administrative pressure on an independent telecommunications operator is the case of Golden Telecom, where the involvement of police and the public prosecutor's office resulted in the eventual dismissal of its general director. In general, the failure to separate the commercial and regulatory activities in this sector could result in heightened uncertainty and a perception of high risk by potential private operators.

While the reform progress in this sector cannot be judged as being satisfactory, Ukrtelecom's investment activity at the beginning of 2002 has

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<sup>6</sup> These 34,300 options, having a maturity of one year from the date of purchase and a total value of UAH 13.72 million, are backed by Ukrtelecom's existing 34,300 trunk lines.

<sup>7</sup> The conflict between Ukrtelecom and Golden Telecom appears mainly to revolve around the fact that the latter was charged more than four times the estimated cost of the connection (USD 6.4 million instead of estimated USD 1.3 million).

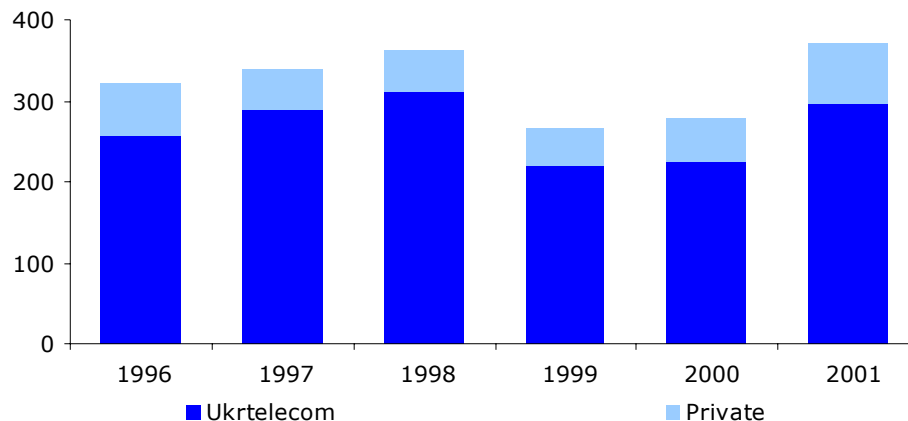




increased<sup>8</sup>. Assuming that Ukrtelecom successfully meets its business plan and that the SCCI correctly estimated the total number of new telephone connections to be installed, the market share of the major local telephone service operator should remain at the 75% level in 2005.

### Graph 3

Quantity of telephone numbers introduced in 1996-2001, in thousands.



Source: <http://www.ukrtel.net/netstat.htm>; own calculations

Utel, which is controlled by Ukrtelecom, has been active in the local telephone service segment since the beginning of 2001. It provides significant support to Ukrtelecom by replacing analogue with digital exchange equipment. In general, the current situation in the telecommunications market is strongly in favour of its dominant operator. It is very likely that its development is highly politicised, the major purpose being to increase Ukrtelecom's investment attractiveness. One suspects that generating of revenues for the state has received a higher priority than the search for an effective new owner.

Ukrtelecom's privatisation, which had been announced long ago, is still an unresolved issue despite the moderate success achieved during the recent privileged subscription<sup>9</sup>. While the Cabinet of Ministers has now approved the terms of the privatisation tender, its timing is still unknown. Even if it were announced soon, the transaction is unlikely to be completed in 2002. Further uncertainty is caused by the ambiguity surrounding the privatisation of Ukrtelecom's ownership share in UMC. In general, the ongoing problems with reforms to the ownership structure present some

<sup>8</sup> 126 kilometers of fiber-optic cable were laid in the first quarter of 2002, which is 37.3% more than during the fourth quarter of 2001. In 2001 Ukrtelecom introduced 296,200 new telephone numbers (32% more than in 2000) and private operators activated 59,300 numbers (a 10% increase as compared to 2000).

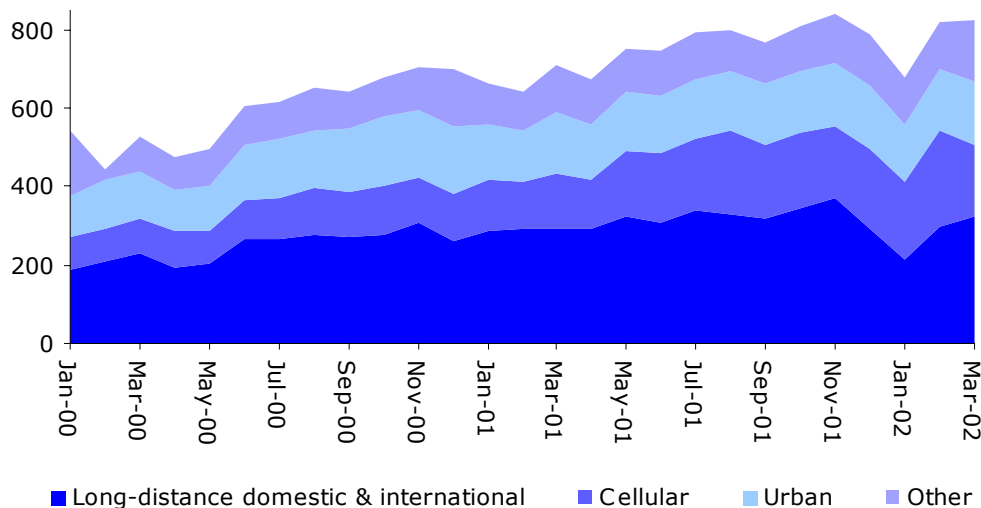
<sup>9</sup> Ukrtelecom sold 7.14% of its shares for UAH 167.07 million during the preferential subscription that took place from October 1, 2001 to February 1, 2002 (98.9% of the company's employees, over 99.9% of its managers, and about 59.3% of the company's pensioners executed their rights under the preferential terms).



evidence of conflicts of interest and of inconsistencies in the strategical development of the telecommunications sector.

#### Graph 4

Incomes in the telecommunications sector, UAH million



Source: Business Week; own calculations

#### 2.1.2 Prospective

The sector's further development urgently needs significant regulatory improvements. The delays with establishing an independent regulatory authority, which should take over the regulatory functions from the SCCI, have already led to unfair competitive advantages for Ukrtelecom. Also, the law on telecommunications should now be adopted, and detailed and transparent normative regulations regarding interconnection - especially with respect to tariff setting - should be developed. Resumption of the licensing of long-distance operators would enhance competition in this field without significantly reducing the investment attractiveness of Ukrtelecom. Taking its eventual privatisation into account, Ukrtelecom-Utel's vertical structure should be reviewed and possibly disintegrated in order to avoid possible future problems with the regulation of a private vertically integrated monopolist.

The only significant positive development in the sector was its continuing income growth during the first quarter of 2002. This growth, which can largely be attributed to increased revenues from the long-distance and local call operations, should make the sector more attractive for both foreign and domestic investors.



## 2.2 Railways

### 2.2.1 Reforms, December 2001 - May 2002

The Ukrainian government continues to develop plans for railway industry restructuring. In particular, the Ministry of Transportation plans to corporatise the railway infrastructure and make it into a separate unit within Ukraine's rail transport corporation. As already mentioned in the previous issue of IMU, the Transportation Ministry has already corporatised 9 repair enterprises. These enterprises account for 62% of the entire repair work to Ukraine's rolling stock. In total the Transport Ministry plans to corporatise 32 repair and engineering enterprises, which at present form part of the state-owned Ukrzalizprom association. After corporatisation they will be included in the State Joint Stock Company Ukrzalizremmash, which incorporates already corporatised repair enterprises.

Two contradicting developments could be observed in this industry during the last half-year. On the one hand, there is a continuing depreciation of assets<sup>10</sup> and a poor quality of service. On the other hand, Ukrainian Railways introduced an extensive investment program outside the industry, such as investments in air transportation. And Ukrzaliznytsia showed a net profit of 164 million in 2001. For these inconsistencies it has been strongly criticized. Yet it is generally recognized that Ukrzaliznytsia cannot achieve substantial improvements in transportation service quality because of its depreciated rolling stock. According to the Ministry of Transportation on average 53% of all assets in the transport sector are fully depreciated, while in the railway sector it averages to 58%, reaching more than 75% for the rolling stock.

The major project among the investment programs by Ukrainian Railways in 2001 was the railway infrastructure improvement along the Kyiv-Kharkiv line, which included straightening the rail floors, electrification<sup>11</sup> and rebuilding of railways stations. The travel time between the two cities is expected to be reduced by one-third, to 6 to 6.5 hours. Once the railway infrastructure has also been reconstructed along Lviv-Kyiv corridor, the transit time through the territory of Ukraine should significantly improve<sup>12</sup>. Furthermore, Ukrainian Railways has increased its investments in transport equipment to UAH 500 million, placing a number of orders for new luxury cars and for repairing electric cars. Lastly, Ukrzaliznytsia actively participates in project financing of the newly created Ukrainian leasing company "Ukrtransleasing"<sup>13</sup>. Ukrainian Railways already finances the construction of two airplanes, planning to eventually finance 10 planes. The

<sup>10</sup> Depreciated capital in transport sector is on average almost 53%, in railways industry it is on average 58%, including depreciated rolling stock at the level of average of 75%.

<sup>11</sup> Currently the line is 60% electrified.

<sup>12</sup> Revenues from freight transit make up about 80% of the total revenues of Ukrzaliznytsia.

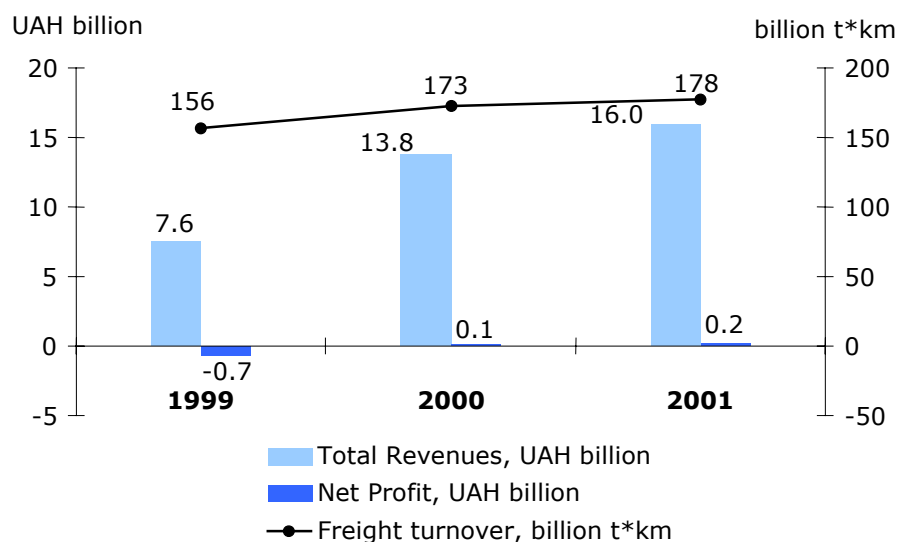
<sup>13</sup> The company was founded in June 2001 to finance transport equipment building. The statutory capital is about UAH 220 million. Currently it is the only company financing airplane construction in Ukraine.



head of Ukrzaliznytsia commented that these plans represent the company's effort to realise additional (non-tariff related) revenues.

It should be recognized that Ukrzaliznytsia's profits and the funds for its investment programs resulted from improvements in its management (Graph 5). During 2001 Ukrzaliznytsia reduced costs by UAH 1.5 billion, while additional revenues from tariff increases amounted to only UAH 588 million. Optimising the transportation schedules saved UAH 500 million, better purchasing management saved about UAH 400 million<sup>14</sup>. The renting out of idle rolling stock brought in about UAH 500 million. The head of Ukrzaliznytsia, Heorhiy Kyrpa, stated that it was possible to increase the company's profitability only after completely switching to monetary payments for freight transportation, and after eliminating the services of intermediaries, who significantly inflated the prices for freight transport.

**Graph 5**  
Ukrainian Railways Revenues and Profits



Source: State Statistics Committee of Ukraine

The Ukrainian Railways authorities explain the revenue increases shown in Graph 5 mostly by a reduction of shadow operations, e.g. barter operations. The increase in profits was relatively slow, but simultaneously Ukrainian Railways has practically eliminated in 2000 and 2001 the indebtedness, which had been accumulating previous years. They also report a net accounting profit, which is different from the profit for tax purposes and the profit for management purposes in Ukraine. Therefore, in fact the profit increases was much higher.

<sup>14</sup> Information disclosed at a conference on antimonopoly regulations for Ukrainian Railways organized by the Antimonopoly Committee of Ukraine on February 20-21.



### 2.2.2 Prospects

The management of Ukrainian Railways is complicated by the cross-subsidization of passenger and freight transportation. On the one hand, Ukrainian Railways cannot modify the regulated tariffs for passenger and freight transportation, and on the other hand they have to finance the transportation of privileged passengers. In fact, certain aspects of social security were shifted from the central government to Ukrainian Railways. In 2001 the deficit generated by passenger transportation was reported to be UAH 1.4 billion (22% lower than the UAH 1.8 billion in 2000), which was entirely borne by Ukrzaliznytsia.

This situation hurts not only Ukrzaliznytsia, but also the passengers. Evidently even a state-owned company like Ukrzaliznytsia is not inclined to increase its deficit by supporting a loss-making business. Thus, Ukrzaliznytsia will attempt to save on passenger transportation by cutting costs in this sector. Loss making of passengers transportation goes hand in hand with fast depreciation of the rolling stock and low quality of service. The low service quality could be one of major factors contributing to the decline in passenger transportation (by 0.2% in 2001 compared to 2000)<sup>15</sup>. Secondly, to compensate for the deficit Ukrainian Railways had to impose additional charges for services related to passengers' transportation or to introduce additional services. This abuse of its monopoly power has led to penalties imposed by the Antimonopoly Committee of Ukraine. Yet, Ukrzaliznytsia has good arguments to justify its position, because it has to bear costs belonging to the social security system.

Thus, non-transparent regulations make it impossible both to properly manage the industry and to monitor management of the industry. The problem of Ukrainian Railways management would be less severe if the cross-subsidization was regulated by specific legislation. In other words, if cross subsidization is impossible to eliminate it should be regulated. For instance, freight transportation could bear the cost of total railway infrastructure maintenance, while passenger transportation would bear only the cost of maintenance of its rolling stock.

## 2.3 Roads

### 2.3.1 Reforms, December 2001 - May 2002

Following a presidential decree<sup>16</sup> the roads regulatory body (Road Service of Ukraine) was separately established from the roads company (State Joint Stock Company "Motor Roads of Ukraine"). State-owned roads were transferred to the statutory fund of the company according to a Decree of the Cabinet of Ministers<sup>17</sup>. At the same time, roads regulation and

<sup>15</sup> It might also be true that this phenomenon relates to a substitution of railway by road transportation due to increasing income levels in Ukraine.

<sup>16</sup> Decree of the President "On Measures to Improve Efficiency of Roads Management in Ukraine" #1056/2001, November 8, 2001.

<sup>17</sup> Decree of the Cabinet of Ministers "On Creation of the State Joint Stock Company "Motor Roads of Ukraine", #221, February 28, 2002.



management are not completely separated from each other. Road Service of Ukraine remains the principal managing body of the Motor Roads of Ukraine. The Decree so far does not regulate the possible future privatisation of the company. However, the government believes that founding this company will facilitate the attraction of investments and loans, which investors would not provide to government bodies otherwise.

Motor Roads of Ukraine remains the major road construction company, which also has a right to contract out some construction work. However financing of road construction and maintenance is very poor, since it continues to be provided through the state budget in 2002. Social policy, a priority target of the government, under very constrained public revenues, forced a contraction of road construction financing. Roads financing has decreased by a factor of six to about UAH 550 million in 2001 compared to 1998. In 2001 the total volume of road maintenance and construction has declined by 9% compared to 2000, while construction of general-purpose roads was reduced by 28.6% to only 138 kilometres.

In general, the situation in the road and road transportation industries is very difficult. 130 of 175 thousand kilometres of roads need rehabilitation, 70% of urban public transport rolling stock is in an emergency situation. At the same time the number of privileged passengers amounts to 17 million or nearly 70% of the total number of passengers transported. The government subsidies are so low, that they cover only 2.5 trips of a privileged passenger per month<sup>18</sup>. Moreover, only about 80% of the budgeted amounts for subsidies are actually spent. The obvious consequence is a quick depreciation of assets in this industry.

### **2.3.2 Prospects**

The former Minister of Transportation, Valeriy Pustovoitenko, had proposed to restore a road fund in Ukraine to guarantee accumulation of capital for road financing. Notwithstanding the general consensus that such a fund should exist, the major problem is the introduction of a system of fund contributions related to roads usage. Introduction of fuel taxation in Ukraine is believed to be quite difficult to administer. Therefore, the solution to this problem is awaiting a taxation system reform in Ukraine.

To finance roads construction and rehabilitation the Ukrainian government should continue to look for forms of public-private partnerships to attract private investments. In particular, concession projects for road rehabilitation could be introduced should the needed amendments to the legislation ever be adopted. The terms of concession contracts could be improved to decrease financial risks. For instance, a basis for bidding could be the least present value of revenues of the concession. Besides, in order to overcome the problem of acceptability of toll systems one could consider implementing a system of shadow tolls. For instance, this could be applied to roads that need rehabilitation or upgrading and handle substantial vehicles flows, like certain segments of major highways in Ukraine.

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<sup>18</sup> Information disclosed by the Head of "Ukrelectrotrans" corporation, Stanislav Beikul.



## 2.4 Power

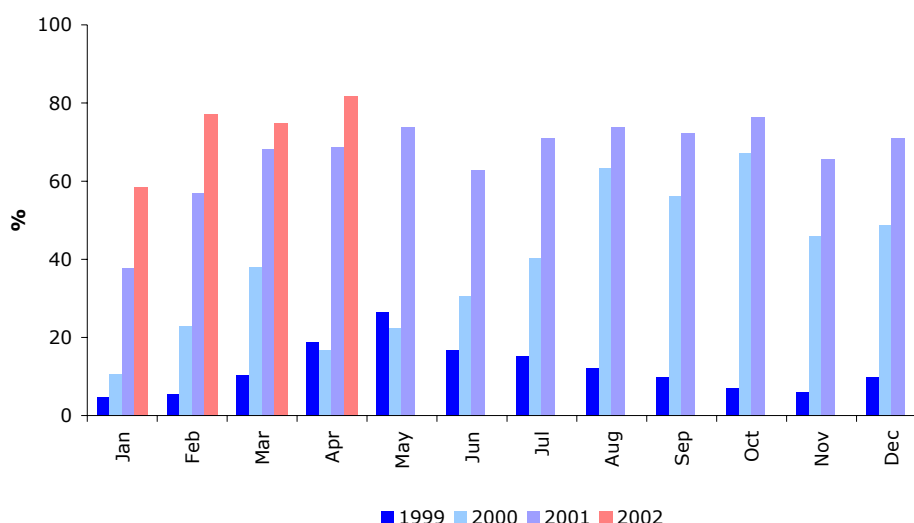
### 2.4.1 Reforms, December 2001 - May 2002

The reforms in the power sector were suspended prior to the parliamentary elections in April 2002, but the situation has not changed since. To establish a consistent governmental policy in this sector remains the main problem on the main agenda. Privatisation of an additional 12 regional power distribution (oblenergos) and power generating companies according to the privatisation plan was postponed for an indefinite period.

The level of cash payments by the oblenergos to the wholesale electricity market remained at the same 70% level between November 2001 and April 2002. Since April 2002 the Cabinet of Ministers substantially decreased the number of customers who could pay for electricity by non-monetary mutual settlements using a special clearing account. The privilege was only retained for coalmines until May. As a result, cash payments to the wholesale electricity reached an historical maximum – about 82% in April (see Graph 6) though the total level of payments decreased by about 10%.

**Graph 6**

Cash payments by oblenergos as a percentage of their total electricity purchases



Source: NERC; Interfax

As during the previous period privileges and subsidies to selected customers are financed through indirect compensation. The losses incurred by the regional energy suppliers due to these privileges came from the gas transit service fees arrears, which NAK Naftogaz Ukrainy (Naftogaz) is obliged to pay to the state. Since Naftogaz does not fulfil its obligations, the losses of the power distribution companies are not being compensated. Thus, inter-enterprise indebtedness does not decline.



Starting on May 1, the National Electricity Regulation Commission (NERC) started compensating all regional electrical companies for commercial transmission and distribution losses<sup>19</sup>. The limit for the amount of compensated commercial losses was set at 7% of the amount of electricity supplied. However, the NERC includes commercial losses in its tariffs for electricity transmission through power lines by those regional distribution companies, which have paid for 100% of the electrical power they supplied, and decreased their commercial losses by at least 3.5% during the last year. Previously, the NERC did not include commercial losses by regional companies in their tariffs.

In 2001, the NERC has changed its algorithm for money distribution from the special clearing account more than one hundred times. Until recently only 70% of the electricity sold to the wholesale electricity market has been paid to the power generating companies in proportion to the amount supplied. Currently the NERC tries to solve the problem of the financial sustainability of the fossil fuel based power generating plants at the expense of the nuclear power company "Energoatom". As a consequence of this cross-subsidisation further serious distortions arise in the power industry.

#### **2.4.2 Prospects**

The government plans to continue with the privatisation of the remaining state owned oblennergos. However, there is no consensus on the time schedule, on the procedure to be followed and on restructuring of the accumulated debts. Transparency of the privatisation process is essential in order to attract foreign investors and to avoid that assets will be sold via "cold" privatisations at lower prices.

The new government formed after the parliamentary elections, does not have the political will nor sufficient support to increase the tariffs for all consumers to cost-covering levels. Thus, the Prime Minister announced that the tariffs for households would be adjusted only to reflect the inflation level, while tariffs for residential consumers have remained unchanged since 1999. However, the energy component is an important component of industrial production, and eliminating the cross-subsidisation of the residential sector by industry may be unavoidable if one wants to ensure the competitiveness of Ukrainian goods on the world market.

Enacting the laws "On the NERC" and "On the wholesale electricity market" by the newly elected parliament would improve the regulatory situation. Regulations for the free access of independent suppliers to the transportation and distribution grids should also be included.

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<sup>19</sup> Commercial losses in nets are all losses above the norm for electricity losses officially established for each oblennerg by the NERC.





## 2.5 Gas

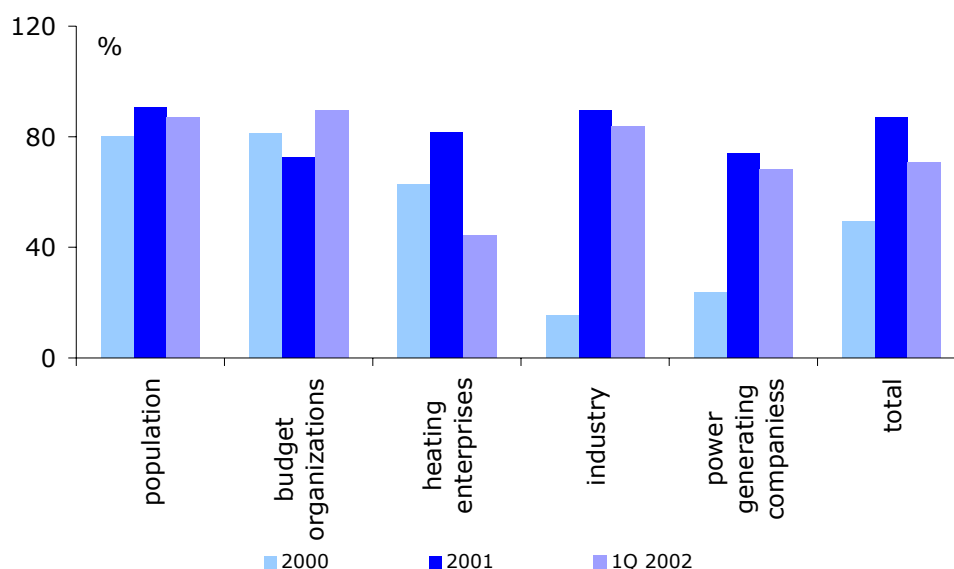
### 2.5.1 Reforms, December 2001 – May 2002

Same as in the power sector no market reforms were observed in the gas sector. The tariff policy has not changed. Tariffs for private households, for budget organisations on all levels and for communal heating enterprises are much lower than those of industry, although one should expect the costs of supply to the first groups to be much higher.

Total payments and cash payments decreased noticeably by about 17% in the first quarter 2002, compared to the previous year. During the first quarter of 2002 consumers paid NAK Naftogaz Ukrayiny 71% of the gas they consumed, including about 70% in cash. The corresponding amounts were 89% and 87% for 2001, and 77% and 49% for 2000 respectively (see Graph 7).

#### Graph 7

Cash payments to NAK Naftogaz Ukrayiny as a %age of the amount supplied



Source: Ministry of Economy; *Energobusiness*, #5, 18-19, 2002

The level of tax payment to the state for transit service was at about 65% of the level approved in the budget for first quarter. As a consequence the subsidies to other utility companies were not paid fully. Because of Naftogaz's indebtedness to the government, it and the State Tax Administration are going to impose strict financial controls on Naftogaz. As a result, state interference in the company's planning and investment decisions is expected to increase.

There are no changes concerning the market structure nor concerning the conditions of gas imports. In return for its transit service for Russia's



Gazprom, Naftogaz<sup>20</sup> is paid in natural gas. Half of the imported Turkmenian natural gas at the Turkmen-Uzbek boarder is paid for by Naftogas with goods and services. As in the previous period, the international corporation Itera, which transports Turkmenian gas bought by Naftogaz through the territories of Uzbekistan, Kazakhstan and Russia is paid for its services with gas. This gas is then sold at the Ukrainian market.

### **2.5.2 Prospects**

Now that the new parliament has been elected, the regulatory environment should be improved in order to increase competition within the industry. Thus, non-discriminatory access to transportation networks for potential natural gas importers, as well as transparent methodologies for determining access fees should be guaranteed. The tariffs for transportation and distribution services should allow the natural monopoly operator to recover its cost. At the same time the regulator has to prevent cross-subsidisation of one service by another (e.g. cross-subsidisation of extraction by transportation) by the natural monopoly. By splitting Naftogaz off from Ukgazvydobuvannya, Ukrtransgaz TD "Gaz Ukrainy" Ukraine would also improve the competitive conditions within the industry. It would also increase the attractiveness of the industry to foreign investors. Regulatory incentives for cost reduction like 'price-cap' regulations would result in price reductions, which in turn would positively effect the competitiveness of Ukrainian enterprises on the world market.

Achieving a 100% payment target level as well as eliminating price distortions implies that such unpopular measures as disconnection from the gas supply and price increases for selected customer groups are enforced. Though these measures might be painful and politically unpopular, it will remain impossible to attract investments to the industry unless the tariffs fully cover costs. Price adjustments should be accompanied by meter installations in order to clearly prove to consumers what they are being asked to pay for.

## **2.6 Water and wastewater**

### **2.6.1 Reforms, December 2001 - May 2002**

In February 2002 the government adopted a special decree "On the reform and developments of the utility sector in 2002-2005 and until 2010" aimed at market restructuring of the utility sector. However, implementation of these reforms was halted on the eve of the parliamentary elections. As was pointed out in a previous issue, only in the few cases where international financial organisations like the World Bank or the EBRD financed rehabilitation projects was corporate governance improved. EBRD also approved loan provisions for the Mariupol and Kherson water utilities that will operate on a contract management scheme. The managing company will be selected from among international water utility companies.

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<sup>20</sup> National joint stock company "Naftogas of Ukraine".



The payment rates, the tariff policy and the installation of consumption meters have not changed substantially compared to the previous period. Thus, the payment rate is about 80%, 45% of households have overdue indebtedness for more than 3 months, cross-subsidisation persists and the level of meter installations is even below the modest planned level.<sup>21</sup> As shown in Table 1, tariffs for households are lower than for industry while the cost of supply to them is expected to be higher.

**Table 1**

Tariffs for water supply in selected cities

City	Cost covering (%)	Consumption norm per capita (m <sup>3</sup> )	Tariffs (UAH)		
			per 1 m <sup>3</sup> per capita for residential sector	per 1 m <sup>3</sup> for budget organisations	per 1m <sup>3</sup> for other customers
Vinnitsia	75	9.00	0.36	1.14	1.14
Dnipropetrovsk	100	9.12	0.46	0.50	0.80
Donetsk	95	6.60	0.40	0.97	3.24
Zaporizhya	70	8.7*	0.42	1.18	1.18
Ivano-Frankivsk	85	6.20	0.46	0.46	0.67
Kyiv	81	9.00	0.52	0.52	1.33
Lviv	84	9.1*	0.56	0.69	2.70
Mykolaiv	53	9.00	0.39	2.36	2.36
Poltava	54	9.10	0.62	4.10	4.10
Sumu	88	9.12	0.62	1.50	1.63
Charkiv	93	11.10	0.75	1.50	1.50
Chmelnytskyi	85	7.50	0.57	0.95	0.95

Source: PADCO

\*maximum norm

A presidential decree has divided the State Committee of Ukraine on Construction, Architecture and Housing Policy (Derzhbud), whose responsibilities included water and wastewater industry, into two separate state committees. One of them – the State Committee of Ukraine on Housing Policy was ordered to administer water and wastewater policies. It is subordinated to the Cabinet of Ministers. However, the legislative framework for implementation has not been adopted yet.

The payment rates for electricity consumption by water supply and wastewater companies are still among the lowest in the country. Disconnections from the grid by regional power distribution companies occurred several times in several regions. However, it is rather difficult to enforce 100% payment for water and wastewater services due to the peculiarities of the current legislation.

<sup>21</sup> According to Ministry of Statistics data, only 8,799 cold water meters and 967 hot water meters were installed in 2001, which represents 11.4% and 2.7% of plan respectively.



### **2.6.2 Prospects**

Installing consumption meters must be forced in order to encourage efficient water usage. This will discipline both water users and the water supply companies. Once meters are in place, the water supply and wastewater companies will not be able any more to compensate for their huge losses and other inefficiencies by unjustified consumption estimates, and thus, there will be an incentive to minimise costs. Though the losses within the nets might differ from region to region, there should not be such huge variations. Regulations like 'yardstick competition' could provide good incentives for minimisation of losses in nets.

Tariff reform remains on the agenda. Tariffs for all consumers must cover costs, and there need to be incentives for any cost reductions implemented by the supply companies. In particular tariffs should cover the tariffs of the water infrastructure maintenance and its development. It should be obligatory for water companies to conclude contracts with users, which would enhance service quality standards. In turn every water supply company should be given the right to disconnect non-paying users, which would create a credible threat for those not complying with the agreement.

The State Committee of Ukraine on Housing Policy should be designed to be an independent regulator. It should be independent from the influence of both market participants and the state. The new housing code should envisage measures aiming at solving the problem of non-payments, especially those consumers who have not paid their bills for a substantial period of time.



## 3 Appendices

### Appendix 1 Infrastructure Indicator evaluation

	Indicator	Telecom			Railways			Roads			Power			Gas			Water and Waste water		
		00-N	01-M	02-M	00-N	01-M	02-M	00-N	01-M	02-M	00-N	01-M	02-M	00-N	01-M	02-M	00-N	01-M	02-M
	EBRD indicator	2.5	2.5	2.5	2.0	2.0	2.0	2.0	2.0	2.0	3.0	3.5	3.5	1.9	2.0	2.1	1.5	1.0	1.0
	IERPC indicator	2.3	2.4	2.2	2.2	1.3	1.4	1.5	1.5	2.2	2.2	2.2	2.2	2.4	2.5	2.5	2.5	1.4	1.4
1.0	Commercialization and privatization	2.0	2.0	1.9	1.9	1.3	1.4	1.5	1.5	2.0	2.0	2.0	2.1	2.4	2.5	2.5	2.5	1.3	1.3
1.1	Ownership	2.0	2.0	2.0	2.0	1.2	1.3	1.3	1.3	2.0	2.0	2.0	2.0	2.2	2.3	2.4	2.4	1.1	1.1
1.1.1	Natural monopoly	1.3	1.3	1.7	1.7	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	3.0	3.3	3.3	3.3	1.0	1.0
1.1.2	Potentially competitive businesses	2.7	2.7	2.3	2.3	1.3	1.3	1.3	1.3	2.7	2.7	2.7	2.7	2.3	2.3	2.7	2.7	1.0	1.0
1.1.3	Ancillary businesses	2.0	2.0	2.0	2.0	1.3	1.7	1.7	1.7	2.3	2.3	2.3	2.3	1.3	1.3	1.3	1.3	1.3	1.3
1.2	Operation	1.8	1.9	1.7	1.7	1.2	1.4	1.6	1.7	1.6	1.8	1.8	1.9	2.5	2.6	2.6	2.6	1.4	1.8
1.2.1	Natural monopoly	1.7	2.0	1.7	1.7	1.3	1.3	1.7	1.7	1.3	1.7	1.7	1.7	2.0	3.0	3.3	3.3	2.0	2.0
1.2.2	Natural monopoly planning and investment decisions	2.0	2.0	1.7	1.7	1.0	1.3	1.3	1.7	1.7	1.7	1.7	1.7	1.7	2.7	2.7	2.7	1.0	1.0
1.2.3	Private sector participation in service contracts	1.7	1.7	1.7	1.7	1.3	1.7	1.7	1.7	1.7	2.0	2.0	2.0	1.7	1.7	1.7	1.7	1.3	1.3
1.3	Organizational structure	2.2	2.2	2.1	2.1	1.4	1.6	1.6	1.6	2.3	2.3	2.3	2.3	2.5	2.5	2.5	2.5	1.7	1.7
1.3.1	Separation of natural monopoly and potentially competitive businesses	2.3	2.3	2.0	2.0	1.0	1.0	1.0	1.0	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	2.0	2.0
1.3.2	Separation of ancillary businesses	2.0	2.0	2.0	2.0	1.3	1.7	1.7	1.7	2.0	2.0	2.0	2.0	1.3	1.3	1.3	1.3	1.0	1.0
1.3.3	Decentralization	2.3	2.3	2.3	2.3	2.0	2.0	2.0	2.0	1.3	1.3	1.3	1.3	2.7	2.7	2.7	2.7	2.7	2.7
2.0	Tariff reform	2.6	2.6	2.6	2.6	1.4	1.5	1.7	1.8	2.2	2.1	2.1	2.0	2.2	2.5	2.6	2.6	2.0	2.2
2.1	Structure of tariffs	2.3	2.4	2.4	2.4	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.7	2.7	2.7	2.7	2.2	2.2
2.1.1	Political vs. regulated operator's	2.0	2.0	2.0	2.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7	3.0	3.0	3.0	3.0	2.0	2.0
2.1.2	Natural monopoly pricing	2.3	2.3	2.3	2.3	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7	2.7	2.7	2.7	2.7	2.3	2.3
2.1.3	Potentially competitive businesses pricing	2.7	3.0	3.0	3.0	1.0	1.0	1.0	1.0	2.7	2.7	2.7	2.7	2.3	2.3	2.3	2.3	1.3	1.3
2.2	Payments	3.0	3.1	3.1	3.1	1.7	1.9	2.3	2.6	2.5	2.3	2.3	2.2	1.9	2.8	2.9	2.9	1.9	2.7
2.2.1	Intraindustry payments ratios	3.0	3.0	3.0	3.0	1.3	1.7	2.3	2.7	3.0	3.0	3.0	3.0	2.0	3.0	3.0	3.0	2.0	3.0
2.2.2	Final consumers collection ratios	3.0	3.3	3.3	3.3	2.0	2.3	2.7	3.0	2.7	2.7	2.7	2.3	2.0	3.0	3.3	3.3	2.0	2.7
2.2.3	State indebtedness	3.0	3.0	3.0	3.0	1.7	1.7	2.0	2.0	1.7	1.3	1.3	1.3	1.7	2.3	2.3	2.3	1.7	2.3
2.3	State funding	2.4	2.4	2.4	2.4	1.7	1.7	1.9	1.9	2.0	2.0	2.0	1.9	2.2	2.2	2.2	2.2	1.9	1.9
2.3.1	Subsidies level	2.7	2.7	2.7	2.7	1.3	1.3	1.7	1.7	2.0	2.0	2.0	1.7	2.3	2.3	2.3	2.3	2.0	2.0
2.3.2	Subsidies procedure	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	1.7	1.7
3.0	Regulatory and institutional development	2.4	2.4	2.2	2.1	1.2	1.2	1.3	1.3	2.4	2.4	2.4	2.5	2.5	2.5	2.5	2.5	2.1	2.2
3.1	Effective regulatory institution	2.4	2.6	2.3	2.2	1.3	1.4	1.5	1.5	2.0	2.1	2.1	2.2	2.7	2.7	2.7	2.7	1.9	2.0
3.1.1	Management selection of competitive businesses	2.7	2.7	2.3	2.3	1.3	1.3	1.3	1.3	2.3	2.3	2.3	2.3	2.0	2.0	2.0	2.0	2.0	2.0
3.1.2	Independence of regulator, insulation from political influence	2.3	2.7	2.3	2.3	1.0	1.0	1.3	1.3	2.0	2.0	2.0	2.0	3.0	3.0	3.0	3.0	2.3	2.3
3.1.3	Transparency of regulation	2.3	2.3	2.3	2.0	1.7	2.0	2.0	2.0	1.7	2.0	2.0	2.3	3.0	3.0	3.0	3.0	1.3	1.7
3.2	Access regulation	2.3	2.3	2.0	2.0	1.0	1.0	1.0	1.0	2.7	2.7	2.7	2.7	2.3	2.3	2.3	2.3	2.3	2.3



## Appendix 2

### General description of the infrastructure indicators

This appendix presents a brief description of the criteria for scoring each indicator.

#### 1. Commercialisation and privatisation

##### 1.1 Ownership

- 1.1.1 **Natural monopoly.** A natural monopoly is a network operator. A score of one means that the whole network is state owned; the score increases with an increasing share of corporatised, privatised and newly constructed private fixed networks in the total length of networks. The maximum score is reached with private ownership of all networks.
- 1.1.2 **Potentially competitive business.** A potentially competitive business is an operator using networks to provide its services; it is a market related to a natural monopoly. A score of one implies that the businesses are part of the state owned natural monopoly. The score increases with separation, corporatisation and privatisation of existing operators, or with increased market penetration by newly established private agents. The maximum is reached when all the businesses are in private ownership.
- 1.1.3 **Ancillary business.** Ancillary businesses are concerned with network construction, its maintenance, inputs supplies, and social infrastructure. A score of one means that these businesses are state owned. The score increases with the degree of separation, corporatisation and privatisation, or the increase in new private establishments.

##### 1.2 Operation

- 1.2.1 **Natural monopoly.** A score of one is given when the natural monopoly is operated as a government department. The score increases with reorganisation into an independent state agency or a company and establishing of an independent regulator. The maximum score is assigned if a private company manages the natural monopoly, and only an independent regulator, established by law, can intervene.
- 1.2.2 **Natural monopoly planning and investment decisions.** A score of one implies political interference in making business and investment decisions. The score increases as commercial objectives such as profitability and operational efficiency grow in importance. The highest score applies if network extensions and new investment



projects are realised solely based on profitability considerations and reflect marginal social costs.

- 1.2.3 **Private sector participation in service contracts.** A score of one means that the private sector does not participate in construction, maintenance or rehabilitation etc. The score increases with increasing participation in these activities by the private sector.

### 1.3 Organisational structure

- 1.3.1 **Separation of natural monopoly and potentially competitive businesses.** A score of one means no separation between the infrastructure and the service providers' managements, as well as separation between the managements of different service providers. The score increases with unbundling of the industry. The highest score applies when different services are provided by separate private companies.

- 1.3.2 **Separation of ancillary businesses.** A score of one means no separation of ancillary business from the natural monopoly or potentially competitive businesses. The score increases with increasing degrees of separation. The maximum score is assigned when ancillary services for the natural monopoly and for potentially competitive businesses are supplied by the market.

- 1.3.3 **Decentralisation.** A score of one implies no or minimal decentralisation and increases with increasing decentralisation. Decentralization is both regional and functional and implies autonomy of decision making at the regional level concerning tariffs and investments. The highest score is assigned when the industry is divided into competing regional operators.

## 2 Tariffs reform

### 2.1 Structure of tariffs

- 2.1.1 **Political vs. regulated operators.** A score of one implies strong political interference in tariff setting. The score increases with declining political interference and its transfer from the central government to the corresponding government agency and finally to the regulatory body. The maximum score is reached for full cost reflective tariff setting by an infrastructure operator regulated by an independent regulator.

- 2.1.2 **Natural monopoly pricing.** A score of one corresponds to pricing below cost accompanied by a substantial amount of cross-subsidisation. The score increases as the tariff approaches the long-run marginal cost reflecting cost covering levels, with cross-subsidisation declining.

- 2.1.3 **Potentially competitive businesses pricing.** A score of one means a lack of cost reflective pricing. The score increases with





markets becoming increasingly competitive and prices approaching market equilibrium levels.

## **2.2 Payments**

- 2.2.1 **Intra-industry payment ratios.** A score of one implies that arrears are constantly accumulating and transactions between companies within an industry are basically non-monetary. The score increases as monetary settlements are carried out and arrears are approaching zero.
- 2.2.2 **Final consumer collection rates.** A score of one means low revenue collection from final consumers (households, companies, budgetary organizations) and constantly accumulating arrears. The score increases as progress with revenue collection is made and services are fully paid for. Apart from a non-linear pattern of evaluation grades with respect to payment percentage improvements in each sector, there is non-homogeneity of the patterns across sectors. The six sectors were divided into two groups in accordance with the potential efforts needed to reach higher payment levels. Telecommunications and roads represent the first group, where high levels of payments are relatively easy to achieve. The railroad, power, gas, and water supply sectors were put into the second group, where comparatively small improvements can be defined as considerable successes.
- 2.2.3 **State indebtedness.** A score of one corresponds to growing arrears for state compensations to privileged consumers. The score improves as this indebtedness is reduced zero.

## **2.3 State funding**

- 2.3.1 **Subsidies level.** A score of one means that some groups of consumers are heavily subsidised by the state in an explicit or implicit form. Both the depth of the subsidisation and the distribution of subsidies are important. The government may pursue a constant practice of debt's forgiving and restructuring. Abstention from implicit and explicit subsidies leads to improved scores.
- 2.3.2 **Subsidies procedure.** A score of one is assigned when the subsidies are directed to service suppliers and are provided in non-transparent ways. The score improves as the process becomes more transparent and income compensations replace price compensations.

## **3 Regulatory and institutional development**

### **3.1 Effective regulatory institutions**

- 3.1.1 **Management selection of competitive businesses.** A score of one means that the management is appointed by state officials. The score increases when the management is elected by the





shareholders and reaches its maximum when the shareholders are private companies or individuals.

- 3.1.2 **Independence of regulator, insulation from political influence.** A score of one is assigned when a government department provides the service. The score increases as a state commission is introduced and an independent regulator is established. The highest score applies when an independent regulator acts according to law.
- 3.1.3 **Transparency of regulation.** A score of one implies an absence of legislation defining clear rules of the game for business and obligations of government bodies. The score increases with the development of legislation and its enforcement, including when the decision-making becomes public. The maximum score is reached when the performance of natural monopolies in an industry is regulated only by an independent regulator in accordance with law and all decisions are disclosed.
- 3.2 Access pricing regulation method.** A score of one means that the access right is arbitrarily determined by the state or the state-owned operator. The score increases as access is regulated by an independent regulator, later negotiated, finally determined by market mechanisms.



## **Appendix 3**

### **Explanations for the infrastructure indicator evaluations given in Appendix 1 (May-November 2001)**

#### **TELECOMMUNICATIONS**

##### **1.0 Commercialisation and privatisation**

##### **1.1 Ownership**

- 1.1.1 Dramatic increase in the investment activity of Ukrtelecom in the first quarter of 2002, which can be observed by both indicators – length of cable laid and activation of new telephone numbers, gives evidence of stable parity in the shares of fixed lines between private and state operators.
- 1.1.2 Delay with the decision on sale of state package in UMC, persistence of Ukrtelecom-Utel vertical structure with overwhelming domination of state ownership as well as de facto administrative restriction on new entries into the international calls segment do not improve situation with ownership structure in potentially competitive markets.
- 1.1.3 No significant changes in the ownerships structure of auxiliary businesses were detected in the first part of 2002.

##### **1.2 Operation**

- 1.2.1 The SCCI retains both regulatory and commercial functions. Negative consequences of this pervasive structure can be observed in unfair competitive advantage acquired by Ukrtelecom & Utel over the rest of telecommunications operators.
- 1.2.2 Decision-making with respect to investment activity of Ukrtelecom and activity of SCCI on introduction of moratorium on licensing in the international calls segment as well as enforcement of privilege subscription through its timing extension testify for the high degree of political influence in the field of natural monopoly management.
- 1.2.3 No significant changes were detected in the structure of companies on development and maintenance of telecommunication networks. Significant share of private activity exists only in mobile segment.

##### **1.3 Organisational structure**

- 1.3.1 No progress in the separation of potentially competitive enterprises from natural monopoly was achieved. Deeper penetration of state monopoly into ISP segment is proved by the extension of Ukrtelecom's clients base from mostly corporate consumers to final ones. In the future this may negatively influence market structure in the sector.



- 1.3.2 Organizational structure of auxiliary businesses remains stable and is dominated by Ukrtelecoms subdivisions.
- 1.3.3 Dominant position of Ukrtelecom in the fixed line telephone segment (80%) accompanied by significant market share of integrated into it Utel company do not allow for substantial decentralization of telecommunication services. Growth of major operators like Kievstar and UMC in mobile segment as well as substantial network effect in the branch testifies for the slight increase in centralization.

## **2.0 Tariffs reform**

### **2.1 Structure of tariffs**

- 2.1.1 Telecommunication tariffs are regulated. Absence of independent regulator raises a question about efficient tariff-setting procedure for final consumers. The share of privileged consumer categories in the fixed-line segment remained stable. Private operators complaints give some evidence that tariffs for interconnection services set by Ukrtelecom are likely to be inadequate to cost structure.
- 2.1.2 Progress in the final consumers tariff rebalancing (rural and urban; local and long distance) was low with marginal improvement via introduction of by-hour payments theme.
- 2.1.3 Mobile segment tariff setting procedure remains the most flexible and cost-structure reflecting. Relatively high economic concentration in the international and intercity segments preserved by administrative barriers to entry prevents decrease in tariffs for final consumers.

### **2.2 Payments**

- 2.2.1 Phone usage is normally paid for.
- 2.2.2 No substantial progress compared to the previous period especially for privileged categories. Government agency arrears remain stable.
- 2.2.3 The indebtedness level is low but constant and is still not eliminated mostly due to discretionary decision-making at the municipal level.

### **2.3 State funding**

- 2.3.1 The number of privileged categories of phone users as well as the subsidy level remain substantial.
- 2.3.2 Municipal subsidies are paid to the fixed phone line operators with low degrees of transparency and high probabilities of discretionary decisions.

## **3.0 Regulatory and institutional development**

### **3.1 Effective regulatory institutions**

- 3.1.1 The management is selected by shareholders, although for major state owned operators the government's involvement remains high.
- 3.1.2 Political independence of SCCI is low as it can be seen from the activity of Ukrtelecom managed by it. Regulatory and commercial



activity simultaneously performed by the SCCI might result in unfair competitive advantage of Ukrtelecom and resulting monopoly power abuse.

- 3.1.3 Transparency of regulation is low especially in the field of interconnection regulation. Antifraud campaign initiated by SCCI and Ukrtelecom is performed in a non-transparent manner and is subject of multiple complaints from other telecommunication operators. The indicator was downgraded from 2.3 to 2.0.

**3.2 Access regulation** Access is provided by spectrum of allocation tenders and operations licensing. However, the opportunity for Ukrtelecom to abuse its market power starts to realize as it was proved during April's disconnections of telecommunications operators performed on a unilateral basis. Administrative barriers to entry into the international and long-distance telephone calls segments persisted and are likely to be maintained till privatisation of Ukrtelecom.

## **RAILWAYS**

### **1.0 Commercialisation and privatisation**

#### **1.1 Ownership**

- 1.1.1 The rail lines are 100% state owned.
- 1.1.2 Passenger and freight transportation are 100% state owned.
- 1.1.3 The construction, maintenance and service enterprises are being corporatised, privatisation is foreseen at a second stage.

#### **1.2 Operation**

- 1.2.1 The railways are regulated by the State Railways Administration, which is integrated into the Ministry of Transport.
- 1.2.2 The State Railways Administration sets as principal goals operational efficiency and profitability of the industry. Investment projects cost-benefit analysis is provided. The indicator is increased from 1.3 to 1.7.
- 1.2.3 Rail line construction and rolling stock maintenance is provided by enterprises being corporatised (Ukrzalizprom, Ukrzalizremmash, Ukrzaliztrans), although the progress of corporatisation is very slow.

#### **1.3 Organisational structure**

- 1.3.1 The railway infrastructure, passenger and freight transportation services are integrated in Ukrzaliznytsia.
- 1.3.2 Almost all the social infrastructure is transferred in communal property<sup>22</sup>. Separate operators within Ukrzaliznytsia manage transportation of different kinds of freight.
- 1.3.3 The railways are split into 6 regional companies each with the right to set tariffs independently for their services. Municipal authorities

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<sup>22</sup> Information of the Head of Ukrzaliznytsia, Heorhyi Kyrpa.



may regulate privileged category tariffs while providing offsetting compensation.

## **2.0 Tariffs reform**

### **2.1 Structure of tariffs**

- 2.1.1 Transportation service tariffs are set for political reasons – to cross-subsidise privileged passengers, since there are not enough funds in the state coffers.
- 2.1.2 Fixed costs are not covered, cross subsidisation of passenger transportation with freight transportation persists. Investment needs planned by Ukrzaliznytsia are covered only by 25%<sup>23</sup>.
- 2.1.3 Tariffs do not reflect infrastructure and rolling stock costs. Tariff for passengers transportation is UAH 0.04 per km.

### **2.2 Payments**

- 2.2.1 Ukrzaliznytsia's indebtedness to Ukrzalizprom and to the state central budget was further reduced. The indicator increased from 2.3 to 2.7.
- 2.2.2 Monetary payments for freight transportation have reached 97%. The level of barter operations is as low as 2%. The indicator was increased from 2.7 to 3.0.
- 2.2.3 State subsidies are provided at levels provisioned in the state central budget.

### **2.3 State funding**

- 2.3.1 85% of passengers transported locally do not pay for the transportation. There are 16 categories of privileged passengers, although within these categories the number of the privileged is restricted. The government still relies on passenger transportation funding at the expense of Ukrzaliznytsia.
- 2.3.2 Subsidies are paid to the railways (service provider).

## **3.0 Regulatory and institutional development**

### **3.1 Effective regulatory institutions**

- 3.1.1 The President appoints the management, although the government body operating the railways is formally independent.
- 3.1.2 The railways regulator is a part of the government and is integrated with the rail line operator. Recent administrative reforms increased the independence of the railway administration in operational decision-making.
- 3.1.3 Tariffs are fixed by legislation; tariffs changes are discussed within the government.

### **3.2 Access is regulated** with government permission.

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<sup>23</sup> Information of the Deputy Head of Ukrzaliznytsia on Economic Issues.



## **ROADS**

### **1.0 Commercialisation and privatisation**

#### **1.1 Ownership**

- 1.1.1 Roads are 100% in state and communal ownership.
- 1.1.2 Transportation enterprises are 90% corporatised. Freight and transportation enterprises are about 30% private.
- 1.1.3 The social infrastructure, services, and automobile maintenance enterprises are mostly private. Publicly owned companies provide road maintenance and construction.

#### **1.2 Operation**

- 1.2.1 Road network regulation and management is separated. However, the regulatory body (Ukrainian Road Service) still remains the principal managing body of the State Joint Stock Company "Motor Roads of Ukraine". The indicator was increased from 1.7 to 2.0.
- 1.2.2 The road network extension is the only priority, efficiency is not taken into account. President of Ukraine has intervened into investments decision by ordering the Cabinet of Ministers to rehabilitate a segment of Kyiv-Kharkiv road.
- 1.2.3 Road construction and maintenance is provided by state owned companies being corporatised, although contracts are still placed in non-transparent ways. Most construction work is done by the state JSC Motor Roads of Ukraine.

#### **1.3 Organisational structure**

- 1.3.1 The roads operation is split off from freight and passenger transportation services.
- 1.3.2 Road construction and maintenance are separated from transportation, few services are contracted out. Truck and bus maintenance is separated from transportation in most cases.
- 1.3.3 Roads are financed and operated at both the central and regional levels. Municipal authorities can make investment decisions on local road construction although in fact they usually lack funds.

### **2.0 Tariffs reform**

#### **2.1 Structure of tariffs**

- 2.1.1 Tariffs for passenger transportation are set by the government, the government intends to rebalance the tariffs.
- 2.1.2 Officially road funding derives from an excise tax on fuel, although the law is not yet enacted. The tax is directed to the general state coffers. The cross subsidisation level is low. 70% of urban transportation rolling stock and 15% of urban transportation infrastructure of is at the edge of breaking down.
- 2.1.3 The trucking and bus transportation markets are competitive, licensing procedures are improving.

#### **2.2 Payments**



- 2.2.1 Payment arrears between enterprises are modest.
- 2.2.2 Payment arrears by final consumers increase in urban transportation. The indicator was decreased from 2.7 to 2.3.
- 2.2.3 The state has financed the sector at the low level; under-funding persists. Construction of general-purpose roads has reduced by 28.6% to only 138 kilometers<sup>24</sup>.

### **2.3 State funding**

- 2.3.1 The number of privileged passenger, who are subsidized, composes up to 70% of total passengers transportation. From 30% to 80% of passengers do not pay for transportation, depending on a region. Subsidies provisioned in the central budget cover only 2.5 trips per month of every privileged passenger<sup>25</sup>. The indicator was decreased from 2.0 to 1.7.
- 2.3.2 Subsidies are paid to the road operator.

## **3.0 Regulatory and institutional development**

### **3.1 Effective regulatory institutions**

- 3.1.1 The government appoints management of the road operator. Road operator is still managed by the regulator, although it is organizationally separated from the road regulator.
- 3.1.2 Road Service of Ukraine, the regulatory body in the sector, is organisationally separated from the government.
- 3.1.3 Tariff regulation principles are publicly discussed, but only whenever a state budget is being adopted. Investments to be attracted to the industry are coordinated by the JSC Motor Roads of Ukraine with the government, which, nevertheless, increases transparency of the company and the government decision-making. The indicator was increased from 2.0 to 2.3
- 3.2 **Access regulation** Access is regulated by licensing. The procedure of licensing remains non-transparent.

## **POWER**

### **1.0 Commercialisation and privatisation**

#### **1.1 Ownership**

- 1.1.1 Controlling stake in 13 regional distribution companies (oblenergos) were sold (out of 27).
- 1.1.2 The nuclear, hydro and fossil fuel generating plants were separated into different companies. The nuclear, hydro generating plants

<sup>24</sup> Road network in Ukraine includes 175 thousand kilometers. 130 thousand kilometers need rehabilitation, including 10 thousand kilometers of general-purpose roads, which should be financed from the central budget. 9 thousand kilometers of roads are not paved.

<sup>25</sup> Information disclosed by the Head of "Ukrelectrotrans" corporation, Stanislav Beikul.



remain 100% state property while three companies based on fossil fuel generating plants partially privatised but the major stock is owned by the state. Three fossil fuel generating plants belonged to Donbassenergo are owned and managed by private company.

- 1.1.3 Social infrastructure, construction and maintenance are treated as part of the natural monopoly.

## **1.2 Operation**

- 1.2.1 Regional distribution companies are stock companies and some of them are in private hands, all are regulated by the NERC. The grid is operated as a part of Ukrenergo.
- 1.2.2 Decision-making is still politically influenced but is likely to decrease due to pressure from private investors (guaranteed profitability).
- 1.2.3 Construction and maintenance is managed by the oblenergos.

## **1.3 Organisational structure**

- 1.3.1 Generation, transmission and distribution are separated into independent companies.
- 1.3.2 There is a minimal degree of separation.
- 1.3.3 Decentralisation is not a high priority in this industry.

## **2.0 Tariffs reform**

### **2.1 Structure of tariffs**

- 2.1.1 Political interference in tariff setting for certain types of consumers persists through pressure exerted on the independent regulator.
- 2.1.2 Cross subsidisation of households, agricultural producers and of closing coal mines by the industry still takes place and cost reflection is not unambiguous.
- 2.1.3 The performance of the wholesale electricity market is far removed from market requirements.

### **2.2 Payments**

- 2.2.1 The situation improved significantly, but some settlements are still made in non-cash form.
- 2.2.2 The collection rate was below 100% and the cash payment remained at 70% level.
- 2.2.3 The state budget foresees 100% payment for consumed power but the actual payments are below this level

### **2.3 State funding**

- 2.3.1 The poorest people are subsidised, the number of privileged categories remains substantial.
- 2.3.2 Subsidies are paid to the oblenergos.

## **3.0 Regulatory and institutional development**

### **3.1 Effective regulatory institutions**

- 3.1.1 The management is appointed by the state





- 3.1.2 The NERC is governed by decrees from the President and the Cabinet of Ministers, there is no law defining its rights and obligations.
- 3.1.3 The new methodology based on a rate-of-return regulation was partially implemented due to strong political interference.
- 3.2 Access regulation** Access is regulated by the NERC, but without a strong legislative base.

## **GAS**

### **1.0 Commercialisation and privatisation**

#### **1.1 Ownership**

- 1.1.1 The trunk pipeline and the distribution net are 100% state property, however, NAK Naftogaz is corporatised.
- 1.1.2 The share of state property in gas extraction is very high, private companies have been involved in gas imports.
- 1.1.3 Construction, maintenance and service efforts are carried out mainly by NAK Naftogaz but unrelated businesses were split off. some contracts on trunk pipeline modernisation are carried out by private company.

#### **1.2 Operation**

- 1.2.1 NAK Naftogaz is subject to supervision by the government and the President; it can however operate as a market company.
- 1.2.2 Commercial objectives are weak, however, commercialisation has increased and debt accumulation for consumed Russian gas was stopped, as was illegal siphoning.
- 1.2.3 Employing private companies to repair and maintain the pipelines has started. The private sector is involved in gas deliveries to enterprises.

#### **1.3 Organisational structure**

- 1.3.1 NAK Naftogaz was split into extraction, transportation and sales.
- 1.3.2 There is a minimal degree of separation.
- 1.3.3 Decentralisation is not foreseen for this industry.

### **2.3 Tariffs reform**

#### **2.4 Structure of tariffs**

- 2.1.1 There still is government interference in tariff setting for some types of consumers.
- 2.1.2 Industrial enterprises have choices; NERC determines the price of transportation. Households and utilities are invoiced at below-cost prices; as a result under-investment in the network persists.
- 2.1.3 A private company carries out a substantial part of gas imports.

#### **2.5 Payments**



- 2.2.1 Arrears accumulation, non-payments or payments in non-cash form and problems associated with them still persist.
- 2.2.2 The payment collection rate (including cash payments) decreased by about 17% and the debt for consumed Turkmenian gas consumed during January – May 20 reached USD 45 m. Therefore, the indicator was decreased from 3.3 to 2.7.
- 2.2.3 The state has not is among the major debtors; however, its indebtedness remained rather stable.

### **2.3 State funding**

- 2.3.1 The poorest households are subsidised; debt delay for enterprises persists.
- 2.3.2 Subsidies are paid to the public sector.

## **3.0 Regulatory and institutional development**

### **3.1 Effective regulatory institutions**

- 3.1.1 The government appoints the management, although NAK Naftogaz is formally independent.
- 3.1.2 NAK Naftogaz is subject to government control.
- 3.1.3 Gas auctions were abolished, distribution costs and the price of natural gas obtained as a fee for Russian gas transit are non-transparent.

- 3.2 Access regulation** Access is regulated by the NERC, but without a strong legislative base

## **WATER AND WASTE WATER**

### **1.0 Commercialisation and privatisation**

#### **1.1 Ownership**

- 1.1.1 Natural monopoly (water distribution and drainage systems) under communal ownership.
- 1.1.2 Potentially competitive businesses (water supply and wastewater treatment) too are in communal ownership.
- 1.1.3 Construction and maintenance are part of the natural monopoly.

#### **1.2 Operation**

- 1.2.1 Water and wastewater services are provided by one company except in a few cities. The number of water utilities operated on contract management scheme increased and the grade was correspondently increased from 1.7 to 2.0.
- 1.2.2 Strong political influence in decision making still persists. The implementation of contract management scheme resulted in grade increase from 1.0 to 1.3.
- 1.2.3 Private sector participation in service contracts is achieved in World Bank or EBRD rehabilitation projects. The grade was increased



from 1.3 to 1.7 due to the increasing number of private companies managing water utilities.

### **1.3 Organisational structure**

1.3.1 No separation

1.3.2 No separation.

1.3.3 Companies perform under the supervision of municipal authorities. However, intervention by the regional administrations is often the case.

## **2.0 Tariffs reform**

### **2.1 Structure of tariffs**

2.1.1 The level of tariffs is determined by municipal officials, primarily in accordance with political considerations. The tariffs for industrial consumers are several times higher than for residential.

2.1.2 Tariffs for residential consumers are at below-cost levels. Natural monopolies charge all costs to consumers and have no incentives for minimising costs.

2.1.3 Potentially competitive businesses are part of the natural monopoly, which sets prices for all services.

### **2.2 Payments**

2.2.1 Payment arrears are significant due to low collection rates.

2.2.2 Collection rates for households remain at a rather low level.

2.2.3 The state has not completely fulfilled its obligation concerning financing privileged consumers out of state funds.

### **2.3 State funding**

2.3.1 The poorest households are subsidised. The amount of subsidisation varies substantially between regions.

2.3.2 Subsidies are paid to the providers of the services.

## **3.0 Regulatory and institutional development**

### **3.1 Effective regulatory institutions**

3.1.1 Regional authorities appoint the management.

3.1.2 There is no independent regulator.

3.1.3 Tariffs are set arbitrarily, justifications for the decisions are not disclosed.

**3.2 Access regulation** There are no rules for access.