UKRAINE

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- 2015, 2016: Combined tariffs increase of 470% for residential gas and 193% for district heating
- 2016: First financial surplus for gas sector
- 2017: Housing and Utilities Subsidy program beneficiaries increase from 1 million to 6.5 million households

With an energy intensity that was more than double that of the European Union, Ukraine, historically, was one of the most energy-intensive economies in the world. In particular, energy subsidies created a significant financial burden. Only when severe gas supply bottlenecks forced the government to take drastic energy conservation measures in the winter of 2014 was heat and electricity tariff increases recognized as the solution to reduce energy spending.

THE CHALLENGE

Until recently, Ukraine's residential gas and district heating tariffs were among the lowest in Europe, but the country's average cost of gas supply was one of the highest. In 2013, Ukraine suffered from regressive subsidies that benefited larger, mainly richer household consumers. The average Ukrainian households used to pay around 20% of the full import price of gas. Overall, the bottom quintile used to get 13% of the (implicit) subsidy in gas and district heating tariffs. Root causes were policies that underprice gas and district heating services. As a result, one saw deteriorating quality of gas and heating delivery due to underinvestment in gas and district heating companies, a high fiscal burden, and energy inefficiency.

THE RESPONSE

Since 2014, ESMAP, through the Energy Subsidy Reform Facility (ESRF), has supported a cross-sectoral team from the World Bank that has provided advice and support the Government of Ukraine in implementing energy tariff and subsidy reforms in an affordable and socially acceptable manner through continuous high-level dialogue, investment, and budgetary support operations with the objective of achieving cost-reflective pricing.

The initial phase of assistance included assessments of the poverty, social, and fiscal impacts of reforms, and dissemination of the results to the Government.

SUMMARY OF 2015-2016 REFORM IMPACTS

	2015	2016
Residential gas tariff average increase and annual average tariff*	180% 2,893 UAH/tcm	470%** 5,885 UAH/tcm
Residential DH tariff average increase and annual average tariff*	58% 509 UAH/Gcal	193%** 949 UAH/Gcal
Financial gain/loss for gas sector (UAH billion)	(11.9)	30.3
Financial gain/loss for DH sector*** (UAH billion)	(1,5)	(3,5)
Share of energy expenditure for bottom 30% households	16.6	25.2
Poverty incidence without HUS	21.9	24.3
Simulated share of households eligible to apply for social assistance	43.0	60.7
Fiscal impact of social assistance programs (% of GDP)	1.05	2.39
Poverty incidence with HUS	20.2	17.2

** Comparison of annual average tariff (including VAT) to 2014 (baseline) average tariffs of UAH 1032/tcm for gas and UAH 32/Gcal for DH*
*** The increase against 2015 is around 104% for natural gas and 84% for heat supply*
**** Based on data f 130 DH companies accounting for 79% of overall heat supply by NEURC licensees*

ESMAP's $20 million Energy Subsidy Reform Facility (ESRF) was set up in 2013 to help countries remove fossil fuel subsidies while protecting the poor. ESRF provides technical assistance to governments, develops tools for assessment and decision-making, and facilitates knowledge-exchange for a global community of reformers.

A campaign to communicate on energy subsidies reforms was launched and further support in strengthening social assistance mechanisms was provided, including: materials and training guides for simplified social assistance programs; strategic rebranding and outreach mechanisms to promote awareness of the Housing and Utilities Subsidy (HUS) program; trainings to improve the efficiency of local welfare offices to improve their efficiency, thereby accelerating program coverage expansion and use.

The later phase of assistance included assessments of energy tariff and subsidy reform outcomes to date, capacity building and knowledge exchanges, and various financial analyses of the natural gas and district heating sectors based on 2016 tariff revisions. There was an, assessment of the HUS's performance and fiscal implications, and focus group discussions were conducted as part of a national survey to assess public perceptions and attitudes toward the reforms.

Supporting both the government and IMF discussions, the cross-sectoral team has conducted rapid response analyses of impacts of a number of scenarios (fiscal, poverty, and social protection) to help the government in making an informed decision.

Since 2014, the team has supported the government to communicate energy tariff reforms, saving energy, and mitigation measures to the public. This communication support included opinion research to assess public attitudes about reforms, messaging workshops to design key campaign messages, 7 training sessions for 278 journalists, media monitoring to enhance press coverage of reforms, development of an animated ad for print, internet, and TV, as well as 51 trainings for 3000 social workers at HUS to improve their customer orientation.

OUTCOMES

Based on the analytical work and assistance provided, regular tariff increases were taken from 2014 to 2016 to meet cost recovery. The government increased tariffs in 2015 and 2016 for a combined increase of 470% for residential gas and 193% for district heating. In April 2016, Ukraine moved to further eliminate unsustainable energy subsidies by unifying household and industrial natural gas tariffs and setting them at the level of import parity.

In 2016, gas tariff increases for households and district heating significantly improved the financial situation of the gas sector and its production, trans-mission, and distribution sub-segments. Household district heating

tariff compensated for the increased fuel costs of the district heating companies and otherwise had little impact on the financial situation of the district heating sector.

On the social protection front, in 2014 and 2015, the government worked towards simplifying social assistance mechanisms by eliminating privileges and providing an option for eligible household to enroll into HUS. It also approved the Gas Sector Reform Implementation Plan, which includes the tariff increases and associated social protection measures. As a result of the team's efforts, Social Assistance Program reforms have increased the share of targeted assistance reaching low-income households. Improved targeting helped contain regressive social assistance spending. From a coverage of approx. 1 million to 6.5 million households in early 2017, the scaling up of the HUS program was a successful mitigating policy measure to the large gas and district heating tariff increases especially for the bottom 30%. In 2016, the program covered 40% of households at a total fiscal cost of around 2.0% of GDP (in contrast to 0.13% of GDP spent in 2014).

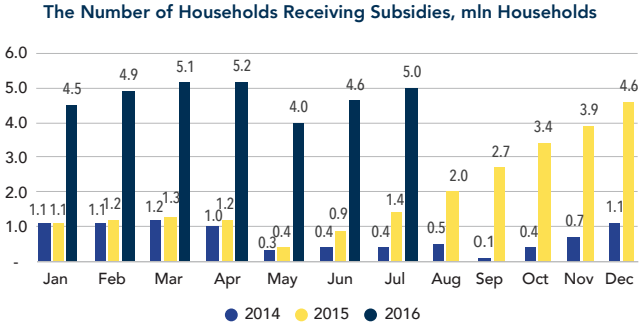
This would have been impossible without the media engagement plan that endeavored to improve the general understanding of subsidy reforms, especially among journalists. In regions where media trainings were conducted, the quality of reporting on energy reforms improved. It is estimated that these newly trained journalists reached approximately 14.1 million people (more than 30% of population), resulting in an extremely positive response from the government.

LOOKING FORWARD

While Ukraine has made significant progress in this complex area of reform, there remain important areas that now need attention.

Gas and district heating tariffs need to be adjusted based on movements of import prices and the exchange rate; these adjustments should be made simultaneously for household gas and district heating supply, and for companies across the gas and district heating supply chain. Recovery of non-fuel operating expenses and investment financings remains an issue for the district heating companies.

To ensure that subsidy payments are settled in a timely and transparent manner, the current system that consists of a



long chain of mutual offsets should be abandoned and, in the initial phase, subsidies should be provided directly to the retail gas suppliers and district heating companies.

Gas tariff setting for households and district heating companies past the expiry of the existing Public Service Operation (PSO) should be clarified and transition measures (e.g. revising subsidy settlement scheme, separating retail supply margin in customers' bills) should be adopted towards eventual full market liberalization.

Targeting of the HUS program needs continued improvement to ensure fiscal sustainability of the program, increased coverage and level of support to low income households, and reduced leakages to higher income households. In the shorter term, targeting can be improved via changes to the HUS eligibility rules, the benefit formula, tighter social norms, imputation of income, and use of ex-post inspections. In the longer term, this requires strengthening of income and wealth verification, reducing errors and fraud.

Proactive national communication efforts should continue – however, emphasis should now be on explaining to the public the simplified procedures and the eligibility rules so as to encourage self-selection and full take-up among low-income households.

NEXT STEPS

The government and the World Bank are continuing to partner with main stakeholders to facilitate timely implementation of reform plans for gas and district heating through continual implementation of the communication strategy on energy reforms and development and implementation of an energy efficiency campaign. The team is assessing achievements, failures and lessons learned of the early reforms to make necessary corrections in course of action for the coming years. The team is continuing capacity building of counterparts, learning and just-in-time technical assistance, support creation and monitoring of the consumer feedback mechanisms in local authorities, energy utilities, communal housing companies and/or administrators of energy efficiency pro-grams. The regulator and energy companies will be supported with the implementation of new tariff setting methodologies in the gas and electricity sector in response to the reorganization of the gas and power markets.

Drawing upon recent focus groups that showed mixed attitudes and a need for better information, the World Bank will support communication through a second round of opinion research to understand attitudes about latest tariff increases, awareness of HUS support, and evaluate the effectiveness of last year's communications. Reporters will be informed, and regionally tailored information about tariffs and HUS will be provided through a second round of journalists' training sessions. Support to improve coordination among donors' public outreach efforts on tariffs and energy efficiency will be offered.

CONCLUSION

ESMAP's assistance, through the Energy Subsidy Reform Facility, helped the World Bank teams conduct an in-depth analysis and provided hands-on support to enable a strong policy response to wasteful energy subsidies.As a result, the government increased tariffs in 2015 and 2016 for a combined increase of 470% for residential gas and 193% for district heating. This helped to improve the financial viability of the gas sector, which made a financial surplus for the first time in 2016. In terms of sheltering the poor from price increases, the government remarkably increased the number of poor beneficiaries under the Housing and Utilities Subsidy (HUS) program from 1 million to 6.5 million households in early 2017. Other work also included training for journalists to ensure informed coverage of the policy decisions and support to the government to strengthen social assistance mechanisms. The World Bank is now exploring the option of providing monetary subsidies (actual funds instead of price or tax rebates) and refining the Housing and Utilities Subsidy to better target the poor.

ABOUT ESMAP

The Energy Sector Management Assistance Program (ESMAP) is a global knowledge and technical assistance program administered by the World Bank. It provides analytical and advisory services to low- and middle-income countries to increase their know-how and institutional capacity to achieve environmentally sustainable energy solutions for poverty reduction and economic growth. ESMAP is funded by Australia, Austria, Denmark, the European Commission, Finland, France, Germany, Iceland, Japan, Lithuania, Luxembourg, the Netherlands, Norway, Sweden, Switzerland, the Rockefeller Foundation, and the United Kingdom, as well as the World Bank.

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