

PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: 88046

Project Name	District Heating Regulatory Reform Support Program
Region	EUROPE AND CENTRAL ASIA
Country	Ukraine
Sector(s)	Energy Efficiency in Heat and Power
Theme(s)	Other Other Public Sector Governance Municipal Governance and Institution Building
Lending Instrument	Recipient-Executed Grant
Project ID	P147651
Recipient	Ukraine
Implementing Agency	National Commission of Ukraine for Regulation of Communal Services
Environmental Category	C
Date PID Prepared/Updated	May 1, 2014
Estimated Date of Appraisal Completion	May 20, 2014
Estimated Date of Board Approval	N/a
Decision	May 25, 2014
Other Decision	N/a

I. Project Context

Country Context

1. Ukraine is one of the 10 most energy-intensive economies in the world.¹ While Ukraine's energy intensity² declined at a rate of 5 percent per year during 1996-2009, it is three times higher than the EU average. Part of Ukraine's energy efficiency problem is structural: Ukraine was an important source of heavy equipment in the former Soviet Union. Nearly 20 years later, most of these assets still use the same technology.

2. Ukrainian primary energy supply is dominated by natural gas. The efficiency with

¹ Measured as the amount of primary energy used to produce one unit of GDP (purchasing power parity – PPP). Source: IEA World Energy Statistics and Balances; World Development Indicators.

² Energy intensity is measured herein as a kilogram of oil equivalent of energy use per constant PPP GDP. Energy use refers to use of primary energy before transformation to other end-use fuels. PPP GDP is gross domestic product converted to 2005 constant international dollars using PPP rates.

which gas is used in Ukraine is well below modern standards, primarily due to the aging asset base. The Government of Ukraine (GoU) plans to improve efficiency through a four-pronged effort: (i) replacing the oldest assets with new equipment; (ii) upgrading plants/ boiler houses with a reasonable remaining operating life; (iii) decreasing energy production from old facilities while investing in new ones; and (iv) providing incentives to improve energy efficiency in all sectors of the economy.

3. The Energy Strategy of the GoU calls for more than a 50 percent reduction in energy intensity by 2030; this goal was reiterated in the recent Energy Strategy update. About 40 percent of the savings would come from structural changes, and the rest would come from technological improvements in industries, heat supply and buildings.

Sectoral and Institutional Context

4. The DH sector is the third largest gas consumer in Ukraine, after households and industry. Ukrainian DH systems were designed based on low-cost energy, mostly gas. They are inefficient but have been reliable. Most buildings in cities and towns are connected to DH networks; about 80,000 high-rise buildings consume 44 percent of the country's heat energy resources.

5. Ukraine's DH sector faces a number of major challenges, including inefficient regulatory practices. Until not so long ago, DH utilities were regulated locally by municipal/ regional governments. As a part of DH sector reform, the GoU transitioned heating prices from local level to central. The President of Ukraine signed a decree creating a Utilities Regulator - the National Commission for Regulation of Communal Services in July, 2011. The newly created Utilities Regulator issues licenses, regulates the licensees and approves tariffs for DH companies that operate boiler houses with a total capacity of over 20 Gcal/h and/or supply over 18,000 Gcal annually. Currently the Utilities Regulator has over 230 licensees.

6. Being newly established, the Utilities Regulator has typical start-up problems. It is not yet fully staffed, not yet fully organized and it lacks a number of procedures, methodologies, rules and regulations. Yet, the Utilities Regulator needs to develop and monitor application of full cost-recovery DH tariffs for its licensees, who are undergoing the regulatory process for the first time. To work efficiently and effectively the Utilities Regulator needs new methodologies, pieces of secondary legislation, operational rules and tools. Many existing laws are outdated as new laws were passed and new principles were established.

7. The World Bank has a comprehensive strategy for improving efficiency within the DH sector in Ukraine, including the US\$382 million Ukraine District Heating Energy Efficiency Project (with US\$50 million to be co-financed by the Clean Technology Fund (CTF)), currently under finalization. The Bank has also developed a suggested path for energy price reforms in Ukraine, together with its impact assessment in collaboration with the IMF. The proposed technical assistance (TA) program will support the long-term reform strategy of the GoU to decrease energy intensity of Ukrainian economy and improve its energy security. The proposed TA would support the Utilities Regulator with transitioning from cost-plus to incentive based regulation, thus promoting improved efficiency in the sector. It will help move the utilities towards financial viability while making DH services better and more affordable to the population.

II. Project Development Objectives

8. The project development objective is to assist the Ukrainian Utilities Regulator with transitioning from “cost plus” to “incentive-based” DH regulation.

III. Project Description

9. The proposed activity will consist of the following components:

10. **Component 1: Support for the development of secondary legislation, transitional methodology and its piloting:** This component will support the development of secondary legislation documents covering transformation of the communal services sector to long-term (3-5 years) full operating and investment cost-recovery tariffs, with creation of incentives for reduction of operation expenses. The component will include updating the existing heat tariff practices and development of a transitional (from “cost plus” to “incentive- based”) methodology for calculation of the heat tariffs. The municipalities/ companies to pilot the methodology will be selected by the end of year 1 of the project implementation.

11. **Component 2: Introduction of sector-wide benchmarking:** This component will introduce a sector-wide benchmarking exercise to identify better performing companies, and understand the cause of better performance so that best practices can be disseminated.

12. **Component 3: Utilities Regulator capacity building:** This component will provide capacity building to the Utilities Regulator, including an expert working full time in Kyiv and inside the Utilities Regulator.

13. **Component 4: Miscellaneous regulation tools:** This component will fund the purchase of miscellaneous regulation tools. Implementation of the Component 1 and 2 requires corresponding process tools including tailor-made software to be provided to the Utilities Regulator.

14. **Component 5: Implementation support and annual audit:** This component will fund project implementation assistance to the Project Implementation Unit (PIU).

IV.

Financing (in EURO Million)

For Loans/Credits/Others	Amount
BORROWER/RECIPIENT	0
SIDA	1,638,600
Financing Gap	0
Total	1,638,600

V. Implementation

15. The project will be implemented the Utilities Regulator over the period of two years. The Utilities Regulator is in a process of establishing a PIU, using its existing staff. The PIU capacity will be strengthened by part-time external FM and procurement consultants; the PIU capacity will be further increased by trainings on Bank procedures conducted by the Bank staff.

16. In order to ensure that the proposed program will not overlap with the work of other

donors as well as enhance quality control of the outputs, a special coordination platform will be established to oversee the activity. As agreed with other IFIs and donors, a Steering Committee will be created that will include representatives of the Utilities Regulator, the World Bank, EBRD, EIB and USAID. It will meet regularly to discuss the progress of the project and related TA provided by other stakeholders.

VI. Safeguard Policies (including public consultation)

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment OP/BP 4.01		X
Natural Habitats OP/BP 4.04		X
Forests OP/BP 4.36		X
Pest Management OP 4.09		X
Physical Cultural Resources OP/BP 4.11		X
Indigenous Peoples OP/BP 4.10		X
Involuntary Resettlement OP/BP 4.12		X
Safety of Dams OP/BP 4.37		X
Projects on International Waterways OP/BP 7.50		X
Projects in Disputed Areas OP/BP 7.60		X

VII. Contact point

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