

CONDITIONAL APPROVAL

of imposition of public service obligations in the natural gas sector of Ukraine for the period of 2017-2018

7 March 2017

1. Introduction

1.1. Proposal for imposition of public service obligations

The Energy Community Secretariat (*the Secretariat*) reviewed and analysed a draft Regulation on Imposing Specific Duties on Natural Gas Market Participants to Meet General Public Interests in Course of Natural Gas Market Performance (Relations in 2017-2018) (*the Draft Regulation*) as proposed by the Ministry of Economic Development and Trade of Ukraine (*the Ministry*) and submitted to the Secretariat for its review and compliance assessment pursuant to Article 67(b) of the Treaty establishing the Energy Community (*the Treaty*), Article 3(11) of Directive 2009/73/EC¹ and Article 11(1) of the Law of Ukraine “On the Natural Gas Market” (*the Gas Law*).²

The Draft Regulation aims at establishing a new regulatory regime for public service obligations in Ukraine’s natural gas sector following the expiry on 1 April 2017 of the currently applicable Regulation on Imposing Specific Duties on Natural Gas Market Participants to Meet Public Interests in Course of the Natural Gas Market Performance (the Transitional Period Relations) as approved by Resolution No 758 of the Cabinet of Ministers of Ukraine of 1 October 2015.³

The Draft Regulation imposes public service obligations on participants of the natural gas market of Ukraine to be carried out under regulated terms and conditions, and in particular:

- (i) the duty of State-owned natural gas producers – PJSC “UkrGasvydobuvannya” and SJSC “Chornomornaftogaz” – to offer natural gas to NJSC “Naftogaz of Ukraine” (*Naftogaz*), and the duty of *Naftogaz* to purchase natural gas from these producers in order to form the resource for natural gas supplies to household customers, religious organisations and district heating companies;

¹ Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, as incorporated and adapted by Ministerial Council Decision 2011/02/MC-EnC of 6 October 2011 on the implementation of Directive 2009/72/EC, Directive 2009/73/EC, Regulation (EC) No 714/2009 and Regulation (EC) No 715/2009 and amending Articles 11 and 59 of the Energy Community Treaty

² Law of Ukraine No 329-VIII of 9 April 2015 “On the Natural Gas Market”

³ Resolution No 758 of the Cabinet of Ministers of Ukraine of 1 October 2015 “On Approval of Regulation on Imposing Specific Duties on Natural Gas Market Participants to Meet Public Interests in Course of the Natural Gas Market Performance (the Transitional Period Relations)” (Official Bulletin of Ukraine, 2015, No 79, 29/2651), as further amended

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- (ii) the duty of *Naftogaz* to offer natural gas to retail natural gas suppliers serving household customers and religious organisations;
- (iii) the duty of retail natural gas suppliers who purchased natural gas from *Naftogaz* to supply natural gas to household customers and religious organisations; and
- (iv) the duty of *Naftogaz* to supply natural gas to district heating companies.

Public service obligations are mandatory on the respective participants of the natural gas market on the entire territory of Ukraine, except for the temporarily occupied territory. The Draft Regulation is envisaged to expire on 1 April 2018.

In the course of elaborating the Draft Regulation, the Secretariat contributed to the discussions and, on 21 February 2017, circulated its initial comments and proposals. On 21 February 2017,⁴ the international stakeholders also submitted their recommendations by a letter to Vice Prime Minister Mr Volodymyr Kistion. The Ministry responded to the Secretariat's comments by electronic mail on 24 February 2017. No further clarifications, as requested by the Secretariat, were provided.

For the purposes of this Conditional Approval, the Draft Regulation was reviewed in the version received by the Secretariat by electronic mail on 1 March 2017 and by an official letter of the Ministry No 3251-08/6986-07 of 2 March 2017 (received on 3 March 2017). Together with the Draft Regulation, the Ministry also submitted an explanatory note (*the Explanatory Note*).

The Secretariat's analysis below covers compliance of the Draft Regulation with the requirements for public service obligations stipulated in Directive 2009/73/EC and the Gas Law.

1.2. Legal background

Pursuant to Article 3(2) of Directive 2009/73/EC, a Contracting Party is allowed to impose on natural gas undertakings in the general economic interest public service obligations which may relate to security, including security of supply, regularity, quality and price of supplies, and environmental protection, including energy efficiency, energy from renewable sources and climate protection. In order to be compliant, such obligations shall be clearly defined, transparent, non-discriminatory, verifiable and shall guarantee equality of access for natural gas undertakings of the Energy Community to national consumers.

Moreover, Article 3(11) of Directive 2009/73/EC requires public service obligations to be notified by a Contracting Party to the Secretariat, including information on their possible effect on national and international competition.

⁴ Letter of 21 February 2017 to the Vice Prime Minister of Ukraine Mr Volodymyr Kistion "Re: future arrangements for regulating household and district heating gas supply and settling subsidies" as signed by representatives of the Delegation of EU to Ukraine, the Energy Community Secretariat, the European Bank for Reconstruction and Development (EBRD), the World Bank, and the International Monetary Fund (IMF)

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In Ukraine, these criteria are transposed and adapted for national application by Article 11 of the Gas Law. It authorises the Cabinet of Ministers, following consultations with the Secretariat, to impose in exceptional cases and for a defined time period special obligations on natural gas undertakings aimed at safeguarding at least one of general public interests listed in Article 11(3). Such obligations are required to be clearly defined, transparent and non-discriminatory as well as to be necessary and proportionate, *i.e.* least restrictive for development of the natural gas market.

Undertakings active in Ukraine's natural gas market are currently subject to public service obligations based on the Regulation approved by Resolution No 758 of the Cabinet of Ministers of Ukraine of 1 April 2015, which expires on 1 April 2017. The Draft Regulation imposes public service obligations for a new one-year cycle until 1 April 2018.

The public service obligations included under the Draft Regulation need to be assessed against the requirements of Directive 2009/73/EC. Their compliance with the Energy Community *acquis* and the Gas Law, and in particular with the criteria legitimising public service obligations, must be fulfilled and continuously ensured throughout the entire application period.

The Secretariat uses this opportunity to recall that public service obligations may be enacted and, if necessary, further amended or adapted only following prior consultations with the Secretariat as required under Article 3(11) of Directive 2009/73/EC and Article 11(1) of the Gas Law.

2. The Secretariat's analysis

2.1. General concept of public service obligations

In EU law, public service obligations evolved as a sector-specific tool for providing services of general economic interest (*SGEIs*). The European Commission (*the Commission*) explains SGEIs as economic activities which deliver outcomes in the overall public good that would not be supplied, or would be supplied under different conditions, without public intervention.⁵ The need for such a public intervention may trigger and justify the imposition of public service obligations on service providers by way of an entrustment and on the basis of a general interest criterion aiming to ensure that SGEIs are provided under defined conditions and their objectives are reached.

In this regard, and before proceeding with the assessment of the specific public service obligations imposed by the Draft Regulation, the criteria for the State's intervention and justification of public service obligations as well as the applicability of public service obligations in the context of the overall regulatory environment of energy markets need to be recalled.

⁵ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – A Quality Framework for Services of General Interest in Europe (COM(2011) 900 final, 20.12.2011), p. 3.

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Within the framework of the European Union and based on case law of the Court of Justice of the European Union (*the Court*), the Commission concluded that States have wide discretion to define public service obligations in line with the needs of end users.⁶ As regards the natural gas sector, the recitals of Directive 2009/73/EC declare that public service requirements should be defined at national level and interpreted on a national basis, taking into account national circumstances; however, subject to European law and, in particular, public service requirements and common minimum standards specified in the Directive.⁷ Consequently, the State's discretion to define public service obligations in line with national circumstances may be exercised only in full compliance with the *acquis*.

In the light of the ruling by the Court in the *Federutility* case,⁸ the State's intervention in imposing public service obligations on natural gas undertakings is required to comply with the criteria established in Article 3(2) of Directive 2009/73/EC having full regard to Article 106 TFEU⁹ and each of such public service obligations has to be justified on the grounds of these criteria so as to prove their legitimacy in compliance with EU law.

In particular, Article 3(2) of Directive 2009/73/EC allows for national legislation imposing public service obligations on natural gas undertakings provided that such obligations:¹⁰

- (i) pursue a general economic interest;
- (ii) comply with the principle of proportionality, *i.e.* impose public service obligations only in so far as is suitable and necessary to achieve their objectives in the general economic interest and, consequently, for a period that is necessarily limited in time; and
- (iii) are clearly defined, transparent, non-discriminatory, verifiable and guarantee equal access for natural gas undertakings of the Energy Community to national consumers.

Most recently, in its ruling in the *ANODE* case,¹¹ the Court reiterated that Article 3(2) of Directive 2009/73/EC must be interpreted as allowing the State to assess whether, in the general economic interest, public service obligations should be imposed on undertakings operating in the natural gas sector provided that, first, all the conditions set out in Article 3(2) are satisfied, specifically the non-discriminatory nature of such obligations, and, secondly, that the imposition of those obligations complies with the principle of proportionality.

⁶ Communication from the Commission on interpretative guidelines concerning Regulation (EC) No 1370/2007 on public passenger transport services by rail and by road (OJ C 92, 29.3.2014, p. 1), p. 6.

⁷ Recitals 44 and 47 of Directive 2009/73/EC

⁸ Case C-265/08, *Federutility*, Assogas, Libarna Cas SpA, Collino Commercio SpA, Sadori Cas Srl, Egea Commerciale Srl, E On Vendita Srl, Sorgenia SpA v Autorità per l'energia elettrica e il gas [2010] 20.04.2010 (*Federutility* case)

⁹ Ex Article 86 of the Treaty establishing the European Community. Applied to Contracting Parties pursuant to Article 19 of the Treaty establishing the Energy Community.

¹⁰ Para. 47 *Federutility* case

¹¹ Case C-121/15, *Association nationale des opérateurs détaillants en énergie (ANODE) v Premier ministre, Ministre de l'Économie, de l'Industrie et du Numérique, Commission de régulation de l'énergie, ENGIE*, 7.9.2016 (*ANODE* case)

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The crucial message to be taken from the Court's interpretation of Article 3 of Directive 2009/73/EC is that while relatively free to define them, the EU Member States – and thus also the Contracting Parties – can use the public service obligations' provision only in exceptional and clearly defined circumstances. Therefore, public service obligations, which are prone to constituting an obstacle to the realisation of an operational internal market in natural gas, shall be an exception and not a rule, and they shall not be invoked to cover purposeful deviations from mandatory internal energy market rules.

2.2. Compliance of the Draft Regulation

a) Existence of a general economic interest

Taking into account that the condition of the general economic interest is not expressly defined by Directive 2009/73/EC and considering the Court's interpretation of this condition in the light of Article 106 TFEU,¹² a Contracting Party is entitled, to the extent complying with Energy Community law, to define the scope and the organisation of its services in the general economic interest and, in particular, to pursue objectives pertaining to its national policy.¹³ At the same time, any interest invoked in the context of establishing public service obligations must contribute or be suitable to contribute to a general economic interest as opposed to individual commercial interests.¹⁴

In exercising the country's discretion, Article 11(3) of the Gas Law establishes a list of national policy areas which are considered to be in the general public interest (equivalent to the general economic interest under Article 3(2) of Directive 2009/73/EC) which include:

- (i) national security, as well as the security of natural gas supply;
- (ii) stability, due quality and affordability of energy resources;
- (iii) protection of the environment, including energy-efficiency, the increase of the share of energy from alternative sources, and reduction of greenhouse gas emissions;
- (iv) protection of health, life and property of the population.

The Draft Regulation suggests that the public service obligations aim to ensure the stability, proper quality and availability of natural gas as well as to maintain a proper safety level of natural gas supply to customers.¹⁵ They thus relate to the security of natural gas supply, regularity and quality of supplies as referred to by Directive 2009/73/EC and the Gas Law. Such an objective in principle can be considered in the general economic interest as defined by Ukraine's national policy.

¹² Para. 26-28 *Federutility* case; Para. 103 Case C-67/96 *Albany* [1999] ECR I-5751; Para. 9 *ANODE* case

¹³ Para. 29 *Federutility* case; Para. 104 *Albany* case; Para. 40-45 *ANODE* case

¹⁴ See the Secretariat's position regarding the justification in the general economic interest of public service obligations imposed on Ukraine's natural gas market participants: Conditional Approval of 22 August 2016 (Re: PSC "Odessa Port Plant") and Rejection of 21 December 2016 (Re: State-owned enterprises).

¹⁵ See first indent of Paragraph 1 of the Draft Regulation.

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More specifically, the proposed regulatory regime introduces public service obligations essentially in the interest of stable supply of natural gas to two groups of final customers – household customers and religious organisations on the one hand, and district heating companies on the other hand. The Secretariat concludes that both the guaranteed supply of natural gas to household customers and religious organisations, as the most vulnerable of final customers, as well as the supply of natural gas intended to serve the stability and affordability of district heating services (*i.e.* supply of heat and/or hot water) to the same household customers and religious organisations, are pursuing a legitimate general economic interest. The same may be concluded in case of natural gas supplies for the combined production of heat and electricity (CHP), where the same quantities of natural gas are used to produce both heat and electricity, which technically cannot be separated from one another.

b) Compliance with the principle of proportionality

Public service obligations imposed on undertakings must comply with the principle of proportionality. The proportionality test requires that those obligations must be suitable to attain the objective pursued and may not go beyond what is necessary to achieve the objective in the general economic interest which they pursue.¹⁶ While the Secretariat currently sees no reason to challenge the suitability of the suggested measures, it will, in the following, assess whether the intervention in Ukraine’s natural gas market inherent in the regulatory regime proposed under the Draft Regulation is limited to what is strictly necessary in order to achieve the objectives of a general economic interest pursued.

Proportionality in this respect and in line with the case law of the Court has two dimensions: *(i)* one related to the gravity of the intervention caused by public service obligations and their impact on the market, and *(ii)* one related to the duration of public service obligations.

i. Gravity of intervention and impact on the market

With regard to the first dimension of the principle of proportionality, the public service obligations proposed must be the least onerous means realistically conceivable in pursuing the objectives of a secure and reliable supply of natural gas to household customers, religious organisations and district heating companies. In other words, the Ukrainian authorities need to establish the necessity of the imposition of the public service obligations in question in a situation where the market alone cannot guarantee the achievement of an acceptable level of the security of supply. This requires separate assessments of *(i)* the scope and conditions of the proposed public service obligations aimed at secure supply of natural gas to household customers and religious organisations, *(ii)* the scope and conditions of the proposed public service obligations aimed at secure supply of natural gas to district heating companies, and *(iii)* the proposed mechanisms for the regulation of prices for natural gas supplied within the framework of public service obligations.

¹⁶ Para. 33 *Federutility* case; Para. 54-55 *ANODE* case

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- *Guaranteed supplies to household customers and religious organisations*

As regards guaranteed natural gas supplies to household customers and religious organisations, the Draft Regulation essentially proposes the extension of obligations already imposed on energy undertakings under the currently applicable regime established by Resolution No 758 of the Cabinet of Ministers of Ukraine of 1 October 2015.

In particular, the Draft Regulation imposes obligations to offer and/or purchase natural gas on State-owned natural gas producers,¹⁷ State-owned supplier *Naftogaz* and retail natural gas suppliers. It also suggests keeping the same structure of mandatory contracts for the sale and purchase of natural gas, including the same standard terms and conditions (e.g. standard supply contracts, unbundling of accounts, etc.).

The Secretariat has approved this public service obligation scheme already on earlier occasions and confirmed its necessity to address and overcome market failure in the retail natural gas market in Ukraine.¹⁸ In the meantime, there were no significant developments in the retail market which would change the situation and, by consequence, the Secretariat's assessment in principle. In particular, competition in and liquidity of wholesale and retail natural gas markets in Ukraine are still very limited.

However, the Secretariat views individual aspects of the scheme introduced by the Draft Regulation as problematic and going beyond what is needed to achieve the objective of secure and reliable supply of natural gas.

Firstly, natural gas retail supply under public service obligations in Ukraine is currently concentrated within the incumbent and partially State-owned regional natural gas distribution and supply companies (*oblgazes*).¹⁹ While household customers and religious organisations do possess a *de jure* right to choose their natural gas supplier pursuant to Article 14 of the Gas Law, doing so would mean losing the benefit of guaranteed supplies as only the incumbent *oblgazes* are allowed to carry out such supplies, including benefiting from the right to purchase natural gas from *Naftogaz* for this purpose, under the public service obligations' scheme in place. Supply by any potential or actual alternative supplier is fraught with the risk of finding no natural gas on the market and thus possible supply disruptions. Such a scheme thus constitutes an advantage which

¹⁷ The Secretariat notices that under current regulatory regime, as established by Resolution No 758 of the Cabinet of Ministers of Ukraine of 1 April 2015, SJSC "Chornomornaftogaz" was not imposed with public service obligations. However, given that the company is owned by the State and the proposed public service obligation in question sustains the same scope and conditions as currently imposed solely on PJSC "Ukrigasvydobuvannya", the Secretariat does not raise any concerns with regard to the gravity of such a proposed obligation or its market effects.

¹⁸ The Secretariat participated in setting the scheme of public service obligations imposed on Ukraine's natural gas market participants under Resolution No 758 of the Cabinet of Ministers of Ukraine of 1 April 2015 and agreed with its justification in principle as of a regulatory measure for the transitional period.

¹⁹ See Paragraph 11 and Annex 1 of the Regulation on Imposing Specific Duties on Natural Gas Market Participants to Meet Public Interests in Course of the Natural Gas Market Performance (the Transitional Period Relations) approved by Resolution No 758 of the Cabinet of Ministers of Ukraine of 1 October 2015 (as further amended).

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contributes to the *de facto* supply monopoly of the *obligees* in their respective service territories and makes market entry by new suppliers and supplier switching all but impossible.

The Secretariat considers that a monopolisation of public service supplies goes beyond what is necessary for ensuring the secure and reliable supply of natural gas to household customers and religious organisations, as long as the same benefit can be achieved from supplies by independent suppliers performing within the same framework of public service obligations. There are at least 200 licensed natural gas suppliers in Ukraine.²⁰ Moreover, the supply of natural gas may not be restricted by territorial factors under Article 41 of the Treaty. In that manner, the currently imposed public service obligations actually benefit the *obligees*, *i.e.* individual undertakings, in conferring them the advantage of markets foreclosed to competition. Thus they go well beyond what is necessary to ensure guaranteed natural gas supply to household customers and religious organisations, as not proportionate. This also violates the principle of non-discrimination as enshrined in Article 3(2) of Directive 2009/73/EC and Article 7 of the Treaty.

Admittedly some provisions of the Draft Regulation could be interpreted as allowing all undertakings licensed for the supply of natural gas, including independent suppliers, to apply to *Naftogaz* for the purchase of natural gas to be supplied within the framework of public service obligations.²¹ However, a systemic analysis of the Draft Regulation casts doubts over such an interpretation. Paragraph 9 read in conjunction with Paragraph 13 of the Draft Regulation could well be understood as still implying a scheme of public service supplies where only *obligees* purchase natural gas from *Naftogaz* and sell to household customers and religious organisations. Also, pursuant to fourth indent of Paragraph 1, a customer is allowed to choose its preferred supplier under market conditions but not within the framework of public service obligations. The Explanatory Note basically repeats, in a summarised form, the relevant provisions of the Draft Regulation and does not elaborate on their practical effects, implementation and enforcement. Consequently, there is at best ambiguity whether independent suppliers are eligible to supply household customers and religious organisations within the framework of public service obligations. Such ambiguity cannot be tolerated in public service obligations which, according to Article 3(2) of Directive 2009/73/EC, need to be defined in a clear manner. The same is required by the principle of legal certainty, a general principle under Energy Community law.

The Secretariat concludes that reserving the right to purchase natural gas from *Naftogaz* to the *obligees* would not only go beyond what is necessary in achieving secure and reliable natural gas supplies to household customers and religious organisations, but also would violate Article 3(2) of Directive 2009/73/EC as well as key provisions and principles of the Treaty.

²⁰ Report on the Results of Activities of the National Commission for State Energy and Public Utilities Regulation of 2015, page 103 (http://www.nerc.gov.ua/data/filearch/Catalog3/Richnyi_zvit_NKREKP_2015.pdf)

²¹ First indent of Paragraph 9 of the Draft Regulation refers to a “<...> supplier that has, in the established procedure, obtained a license for conducting the activity of natural gas supply <...>” what could be understood as covering both incumbent and independent natural gas suppliers.

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The Secretariat requests the Ministry to redraft the relevant provisions of the Draft Regulation so as to support the clear and unambiguous understanding that independent natural gas suppliers are also eligible to supply their household customers and/or religious organisations within the framework of public service obligations and, for this purpose, to purchase natural gas from *Naftogaz* under the terms and conditions stipulated in the Draft Regulation. Given that the supply of natural gas within the framework of public service obligations would be carried out by independent suppliers pursuant to individual agreements with its customers, *i.e.* as an option and not as an obligation, the *obligates*, as listed in the Annex to the Draft Regulation, will remain as the guarantors of natural gas supplies to household customers and religious organisations, especially in case the latter are rejected by an independent supplier.

Secondly, the Draft Regulation may be understood in a manner that *Naftogaz* is still envisaged as the only possible wholesale natural gas supplier for retail suppliers acquiring natural gas to be supplied to household customers and religious organisations. While retail suppliers are allowed to choose their wholesale supplier,²² there are certain explicit incentives for retail suppliers to purchase natural gas from *Naftogaz* still suggested by the Draft Regulation. In particular, first indent of Paragraph 13 expressly links the supply of natural gas to household customers and religious organisations with the retail supplier's right to apply the price margin envisaged for the wholesale purchase of natural gas from *Naftogaz*. Any exclusivity in *Naftogaz's* role as of a wholesale supplier would be a violation of the right of eligibility granted to all customers, including retail natural gas suppliers, under Article 3(6) of Directive 2009/73/EC and Article 14(1) of the Gas Law. Moreover, it discriminates other wholesale suppliers in favour of *Naftogaz* and prevents new potential suppliers to enter the market. Imposing such exclusivity and market restrictions would also not be proportionate to ensure secure and reliable supplies of natural gas to household customers and religious organisations.

The Secretariat requests the Ministry to redraft the relevant provisions of the Draft Regulation so as to support the clear and unambiguous understanding that retail suppliers are allowed to purchase natural gas for the purpose of supplying household customers and religious organisations from any other wholesale suppliers, in particular if the natural gas price of such alternative suppliers is not higher than the regulated price applied by *Naftogaz* under the terms and conditions stipulated in the Draft Regulation. *Naftogaz* would remain as a wholesale supplier of last resort for supplying household customers and religious organisations if no alternative offers are available on the market.

And, *thirdly*, notwithstanding otherwise equal treatment of household customers and religious organisations within the suggested scheme of public service obligations under the Draft Regulation, twelfth indent of Paragraph 12 suggests introducing a price coefficient of 0.5 to be applied for supplies of natural gas to religious organisations and to district heating companies for rendering their services to religious organisations. This means that, in practice, religious organisations will be charged for natural gas and district heating services significantly less than

²² Fifth indent of Paragraph 1 of the Draft Regulation entitles retail suppliers, including those supplying natural gas under public service obligations, to choose a wholesale supplier for the needs of their economic operations.

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other comparable customers, including household customers. While the Secretariat does not in principle object to a specific status already granted to religious organisations within the framework of public service obligations compared to other non-profit organisations, considering this as a matter of national policy, such an exclusive pricing is seen as not proportionate. In the Secretariat's opinion, even if allegedly the amounts of natural gas and/or district heating services required for satisfying the consumption demand of religious organisations is negligible, such a preferential treatment discriminates other customers subject to special protection, primarily – household customers. Thus the Ministry is requested to refuse such an exclusive pricing mechanism.

- *Guaranteed supplies to district heating companies*

Unlike the proposed public service obligations addressing supply to household customers and religious organisations, the Draft Regulation extends the scope of public service supply of natural gas to district heating companies as compared to the currently applicable regime established by Resolution No 758 of the Cabinet of Ministers of Ukraine of 1 October 2015.

The supply of natural gas to district heating companies within the framework of public service obligations was expressly limited by Resolution No 758 to the amounts of natural gas necessary for providing secure and accessible district heating services (*i.e.* supply of heat and/or hot water) to household customers and, following later amendments, also to religious organisations²³ and to institutions and organisations financed by the State and local budgets.²⁴ By contrast, the Draft Regulation envisages that such natural gas supplies shall serve *any* use of natural gas by district heating companies. The Draft Regulation expressly underlines the extension of the use of natural gas purchased by district heating companies within the framework of public service obligations for “*all categories of the use of natural gas*”.²⁵

The principle of proportionality, however, requires that natural gas supplies to district heating companies which deviate from market conditions, *i.e.* within the framework of public service obligations, are limited to ensure the stability and affordability of district heating services (and, in the case of CHP, supplies of electricity) to vulnerable final customers or other final customers subject to special protection – household customers and religious organisations, especially during the heating season. All other activities performed by district heating companies, including supplying district heat to industrial customers and non-CHP electricity production, seem not to be covered by the objective allegedly pursued, *i.e.* security of natural gas supply to a limited number of protected customers. Rather, they are to be considered commercial activities related not to public interest but to business interests of individual companies. The Secretariat sees no reason why the natural gas necessary for their benefit cannot be acquired on market conditions.

²³ Resolution No 872 of the Cabinet of Ministers of Ukraine of 30 October 2015 “On Additional Measures for Social Protection of Communities” (Official Bulletin of Ukraine, 2015, No 88, 110/2945)

²⁴ Resolution No 704 of the Cabinet of Ministers of Ukraine of 5 October 2016 “On Amendments to the Regulation on Imposing Specific Duties on Natural Gas Market Participants to Meet Public Interests in Course of the Natural Gas Market Performance (the Transitional Period Relations)” (Official Bulletin of Ukraine, 2016, No 83, 215/2731)

²⁵ See Paragraph 3(1) and first indent of Paragraph 11 of the Draft Regulation.

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The Secretariat therefore considers that extension of public service supplies of natural gas to district heating companies beyond the scope of serving household customers and religious organisations, given their clearly commercial nature in the interest of individual district heating companies and not in the public interest, is excessive and thus not necessary in view of the objective pursued. It would also constitute an unjustified advantage for industrial customers of district heating services and cogenerated electricity, and distort the market for electricity. However, the impact of the Ministry's proposed interventions in the energy markets in favour of district heating companies is not considered in the Explanatory Note.

The Secretariat is of the opinion that market distortions in favour of private commercial interest of selected market participants rather than in a clearly defined public interest within the meaning and scope defined under Article 11(3) of the Gas Law and Article 3(2) of Directive 2009/73/EC may not be considered as proportionate to achieve the goal of security of gas supply. Hence, natural gas supply to district heating companies within the framework of public service obligations may be justified in the general economic interest only for providing district heating services to household customers and religious organisations and, as the case may be, for combined production of heat and electricity (CHP). Natural gas for any other operations of district heating companies shall be purchased on the market.

The Secretariat requests the Ministry to clearly limit the scope of the public service obligation to natural gas supplies to district heating companies only for the amounts of natural gas necessary for rendering district heating services (*i.e.* supplying heat and/or hot water) and supplying cogenerated electricity to household customers and religious organisations.

- *Regulation of natural gas prices*

The regulation by the State of commodity or service prices deviating from market based pricing have to be justified by the requirements of Article 3(2) of Directive 2009/73/EC and Article 11 of the Gas Law as public service obligations, including the principle of proportionality.

In particular, the Court held that the State's intervention consisting in requiring certain suppliers to offer natural gas to final customers at regulated tariffs constitutes by its very nature an obstacle to the achievement of a competitive market in natural gas and that obstacle exists even though the intervention does not preclude competing offers from being made at lower prices than those tariffs by any supplier in the market.²⁶ Therefore, public service obligations relating to the price of supply of natural gas should be imposed on natural gas undertakings provided that, first, all the conditions set out in Article 3(2) of Directive 2009/73/EC are satisfied, specifically the non-discriminatory nature of such obligations, and, secondly, that the imposition of those obligations complies with the

²⁶ Para. 33 *ANODE* case

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principle of proportionality.²⁷ In this regard, a method of determination of prices may not go beyond what is necessary for achieving the objectives of the general economic interest pursued.²⁸

It is understood that the regulation of natural gas prices within the framework of public service obligations proposed by the Draft Regulation aims at securing the affordability of natural gas, on the one hand, and of district heating supplies, on the other hand, to the most vulnerable categories of final customers – household customers and religious organisations. The Secretariat reiterates that such an objective in principle is justified as pursuing the general economic interest defined by Ukraine’s national policy.

However, the price regulation mechanism stipulated in the Draft Regulation still raises certain doubts regarding its proportionality and, in particular, the impact of the State’s intervention on the market. The regulation of prices within the framework of public service obligations must be limited to what the market conditions cannot achieve. By consequence, public service obligations consisting in price regulation must constitute the least possible obstacle for achieving a competitive market in natural gas. The Secretariat’s initial comments regarding the pricing mechanism were not reflected by the Ministry in the Draft Regulation, and no further elaborations were provided in the Explanatory Note.

In this respect, the Secretariat considers that instead of a fixed price for natural gas to be purchased by *Naftogaz* from the State-owned natural gas producers and, subsequently, used as a reference price for *Naftogaz*’s sales to retail suppliers and supplies to district heating companies,²⁹ a price setting mechanism (formula) should be applied, including an adjustment to natural gas import parity price. Such pricing mechanism would incentivise domestic production of natural gas and would equalise competitive powers of domestic producers and importers. The fixed price currently proposed in the Draft Regulation is below the import parity level.

Moreover, in the Secretariat’s opinion, the pricing formula proposed by the Draft Regulation for the calculation of natural gas prices at the import parity level³⁰ needs to be adjusted more frequently (on monthly basis) and should introduce adequate adjustment mechanisms to reflect the import parity price and to avoid *Naftogaz* and other suppliers incurring losses or generating excessive revenues due to the differences of regulated natural gas prices for public service supplies and import prices. The proposed condition that the regulated price shall be adjusted (recalculated) only in case it exceeds 10% of the import parity price³¹ does not provide for enough volatility of market prices and increases the probability of losses or excessive revenues.

²⁷ Para. 53, 60 and 73 *ANODE* case

²⁸ Para. 64-66 and 73 *ANODE* case

²⁹ UAH 4.849 for 1.000 cubic meters (excluding VAT). See first indent of Paragraph 6 and first indent of Paragraph 12 of the Draft Regulation.

³⁰ See second indent of Paragraph 12 of the Draft Regulation.

³¹ See tenth indent of Paragraph 12 of the Draft Regulation.

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Finally, the pricing formula proposed by the Draft Regulation does not include the constituents of domestic natural gas transmission and distribution tariffs. In other words, the regulated price is proposed to be calculated without adding the costs of the domestic transportation of natural gas. This could mean that all natural gas quantities aimed for supplies within the framework of public service obligations will be sold by *Naftogaz* at a virtual trading point at a regulated price without transportation costs and that retail natural gas suppliers and district heating companies themselves would have to book the capacities for transportation of natural gas up to the consumption points and pay transmission and/or distribution tariffs. The Secretariat considers that such natural gas trading arrangements would imply that natural gas transmission and distribution tariff methodologies are fully implemented without any deviations based on the pricing formula applied for public service supplies. However, neither the Draft Regulation nor the Explanatory Note confirms such an understanding. Simply omitting any reference to the domestic transmission and distribution tariffs from the price regulation does not provide for the necessary legal certainty in that respect. Rather, the Draft Regulation should clearly establish that domestic natural gas transmission and distribution tariffs will have to be added to the regulated price for public service supplies as calculated based on the methodology adopted by the National Commission for State Energy and Public Utilities Regulation (*the Regulator*).

Additionally, the Secretariat notices that the Draft Regulation allows *Naftogaz* and retail natural gas suppliers to apply the price margin (mark-up) of 3.2% on the regulated natural gas price.³² Under the Secretariat's estimations, such a price margin would be doubled at the retail level compared to currently applicable margins. Since the constituents of the proposed price margin are not clear, nor they are elaborated in the Explanatory Note, there is a risk that such vague regulation will allow retail natural gas suppliers imposed with public service obligations, and primarily *obligees*, earning excessive returns. Thus relevant provisions lack of necessary transparency and legal certainty.

The Secretariat requests the Ministry to amend and clarify the relevant provisions of the Draft Regulation respectively by improving the pricing mechanism for regulated natural gas prices to ensure its legal certainty, clarity and proportionality.

ii. Duration

According to the Court's case law, a public service obligation must be limited in duration to what is strictly necessary in order to achieve its objective so as not to render permanent a measure which, by its very nature, constitutes an obstacle to the realisation of an operational internal market in natural gas.³³

The Draft Regulation is proposed to apply for a clearly defined period of time – until 1 April 2018. This in principle would correspond to the limited duration as required under Article 3(2) of Directive 2009/73/EC and Article 11(1) of the Gas Law.

³² See first indent of Paragraph 12 and first indent of Paragraph 13 of the Draft Regulation.

³³ Para. 35 *Federutility* case; Para. 53 *ANODE* case

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It is important, however, to ensure that public service obligations do not evolve into a long-term arrangement simply justifying deviations from market principles and obstructing the development of a competitive and liquid natural gas market in Ukraine. While the Secretariat agrees, subject to the conditions following from the present analysis, with the principle necessity for the imposition of public service obligations in the natural gas sector for another one-year cycle, it must be ensured that the performance of these obligations is closely monitored within the context of the overall functioning and development of the natural gas market. Such monitoring shall be executed by the Regulator, pursuant to Articles 4(3)(14) and (24) of the Gas Law, at least on quarterly basis.

c) Clear definition, transparency, non-discrimination, verifiability and non-restrictiveness

Article 3(2) of Directive 2009/73/EC and Articles 11(1) and (2) of the Gas Law also require for public service obligations to be clearly defined, transparent, non-discriminatory, verifiable and guarantee equal access for natural gas undertakings of the Energy Community to national consumers.

Taking into account the legal uncertainties regarding the scope of public service obligations imposed by the Draft Regulation including the natural gas pricing mechanism, the Secretariat considers the introduced public service obligations as not clearly defined.³⁴ These uncertainties need to be eliminated by the necessary corrections and adjustments to the Draft Regulation requested. The Ministry is therefore requested to correct the above indicated uncertainties. The same goes for the instances of discrimination identified above.

d) Compliance with the State aid acquis

Article 18 of the Treaty established mandatory requirement for Contracting Parties with regard to the compliance with the *acquis* on competition and State aid. Any practices deviating from respective requirements shall be assessed on the basis of criteria arising from the application of the rules stipulated in Annex III to the Treaty.

In implementing imposed public service obligations, individual energy undertakings may receive an economic advantage which they would not have obtained under normal market conditions. Such an economic advantage, under certain conditions, may qualify as State aid and thus would be required to be justified and monitored in compliance with the Energy Community *acquis*. Therefore the Secretariat requests the Ministry to task the Antimonopoly Committee of Ukraine (*the Antimonopoly Committee*) in monitoring the implementation of public service obligations from the perspective of State aid.³⁵

³⁴ Note of DG Energy & Transport on Directive 2003/54/EC and 2003/55/EC on the internal market in electricity and natural gas – Public service obligations, 16.1.2004, p. 5 (Section 2.2).

³⁵ Respective provision shall be included in the decisive part of the Resolution of the Cabinet of Ministers of Ukraine by which the Draft Regulation will be approved.

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3. The Secretariat’s findings

Based on the review and assessment of the Draft Regulation, the results of which are presented herein, the Secretariat found out that individual aspects of the public service obligations’ scheme introduced by the Draft Regulation are problematic and non-compliant with the criteria for public service obligations and internal market rules established by Directive 2009/73/EC and the Gas Law as going beyond what is necessary to achieve the objectives of general economic interests pursued, being discriminatory and disproportionate, and lacking of legal certainty. In particular:

1. The Draft Regulation implies that natural gas retail supply under public service obligations in Ukraine is intended to be kept concentrated within the incumbent and partially State-owned regional natural gas supply companies (*oblgazes*), thus sustaining the monopoly of public service supplies to household customers and religious organisations from which the *oblgazes* are the sole beneficiaries and which *de facto* makes market entry by new retail natural gas suppliers and supplier switching all but impossible.
2. The Draft Regulation also implies that *Naftogaz* is still envisaged as the only possible wholesale natural gas supplier for retail suppliers acquiring natural gas to be supplied to household customers and religious organisations thus discriminating other wholesale suppliers in favour of *Naftogaz* and preventing new potential suppliers to enter the market.
3. Preferential reduction of regulated prices for supplies of natural gas to religious organisations and to district heating companies for rendering their services to religious organisations discriminates other comparable customers subject to special protection, primarily – household customers.
4. The proposed scope of a public service obligation to supply natural gas to district heating companies for all categories of the use of natural gas clearly extends to commercial interests of individual district heating companies and thus is excessive as going well beyond the objective of providing household customers and religious organisations with stable and affordable district heating services, constituting an unjustified advantage for industrial customers of such services and of cogenerated electricity, and distorting the market of electricity.
5. Regulation of natural gas prices for supplies within the framework of public service obligations, as introduced by the Draft Regulation, does not include an appropriate and adequate adjustment mechanisms to reflect the natural gas import parity prices, it leaves a varying probability for *Naftogaz* and other suppliers incurring losses or generating excessive revenues, it does not include the constituents of domestic natural gas transmission and distribution tariffs and their application is left uncertain, and the suggested price margin (mark-up) allowed for suppliers is not transparent.

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4. Conclusions

The Secretariat concludes that the Ministry's proposed Draft Regulation can be considered as compliant with Articles 3(2) and (11) of Directive 2009/73/EC and Article 11 of the Gas Law subject to the following conditions:

1. All customers shall sustain their right to freely choose and switch their natural gas supplier notwithstanding the imposed public service obligations, including the right of household customers, religious organisations and district heating companies to choose and switch their retail natural gas supplier as well as the right of retail suppliers to choose and switch their wholesale natural gas supplier.
2. Independent natural gas suppliers shall be clearly and unambiguously allowed to supply their household customers and/or religious organisations within the framework of public service obligations and, for this purpose, to purchase natural gas from *Naftogaz* under the terms and conditions stipulated in the Draft Regulation.
3. Retail natural gas suppliers shall be clearly and unambiguously allowed to purchase natural gas for the purpose of supplying household customers and religious organisations from any wholesale supplier, in particular if the natural gas price of such a supplier is not higher than the regulated price applied by *Naftogaz* under the terms and conditions stipulated in the Draft Regulation.
4. Regulated natural gas prices within the framework of public service obligations paid by religious organisations and by district heating companies serving religious organisations shall not be preferentially reduced and shall be made equal to regulated natural gas prices paid by household customers and by district heating companies serving household customers respectively.
5. Natural gas supplies to district heating companies within the framework of public service obligations shall be limited to the amounts of natural gas necessary for providing district heating services to household customers and religious organisations and, as the case may be, for combined production of heat and electricity (CHP).
6. Proposed mechanism for setting regulated natural gas prices for supplies within the framework of public service obligations shall be clearly defined, transparent and proportionate, and in particular:
 - instead of fixed natural gas reference price for supplies within the framework of public service obligations, price setting mechanism (formula) shall be applied, including its adjustment with natural gas import parity price;

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- regulated natural gas price shall be adjusted on more frequent and regular basis (on monthly basis) and shall introduce adequate adjustment mechanisms to reflect the import parity price;
 - legal provisions referring to the application of domestic natural gas transmission and distribution tariffs within or, as the case may be, outside the formula of regulated natural gas prices for supplies within the framework of public service obligations shall be elaborated;
 - the constituents of the price margin (mark-up) allowed to be applied by *Naftogaz* and retail natural gas suppliers with regard to supplies within the framework of public service obligations shall be revealed and set in a transparent manner.
7. Limited duration of public service obligations shall be ensured and it shall be clearly established that their performance is closely monitored by the Regulator within the context of the overall functioning and development of Ukraine’s natural gas market at least on quarterly basis.
8. The role of the Antimonopoly Committee shall be envisaged in monitoring the implementation of public service obligations from the perspective of State aid.

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