

EXPLANATORY NOTE

to the draft Resolution of the Cabinet of Ministers of Ukraine “On Approval of the Regulations on Imposing Specific Duties on Natural Gas Market Participants to Meet General Public Interests in Course of Natural Gas Market Performance (Relations in 2017-2019)”

1. Rationale for the adoption of the act

Pursuant to Article 11 of the Law of Ukraine “On the Natural Gas Market”, the Cabinet of Ministers of Ukraine may impose on subjects of the natural gas market special obligations aimed at safeguarding general public interests in the course of the functioning of the natural gas market. Such special obligations, following consultations with the Energy Community Secretariat, may be imposed only in exceptional cases and for a defined period of time, and they shall fulfil the criteria stipulated in Articles 11(1)-(3) of the Law of Ukraine “On the Natural Gas Market”. Respective criteria correspond with mandatory requirements qualifying public service obligations established under Article 3(2) of 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 adapted for the Energy Community, implementation of which is committed by Ukraine under the Treaty establishing the Energy Community.

Currently, special obligations imposed on natural gas market participants in Ukraine are regulated by Resolution No 187 of the Cabinet of Ministers of Ukraine of 22 March 2017 “On Approval of the Regulations on Imposing Specific Duties of Natural Gas Market Participants to Meet General Public Interests in Course of Natural Gas Market Performance” (hereinafter – the CMU Resolution No 187). This Resolution establishes a number of measures based on which NJSC “Naftogaz of Ukraine” and incumbent regional suppliers are obliged to serve defined segments of Ukraine’s natural gas market at regulated conditions. In particular, NJSC “Naftogaz of Ukraine” mandatorily supplies natural gas to incumbent regional suppliers serving household customers and religious organisations as well as to heat producers for all categories of their natural gas use, whereas incumbent regional suppliers mandatorily supply natural gas to household customers and religious organisations. NJSC “Naftogaz of Ukraine” is also granted with an exclusive right for priority off-take of natural gas domestically produced by its subsidiary undertakings – PJSC “UkrGasvydobuvannya” and PJSC “Chornomornaftogaz”.

Despite that *de jure* the CMU Resolution No 187 allows the customers covered by its established scheme of guaranteed supplies of natural gas to choose and switch their supplier, as required under Article 14(1) of the Law of Ukraine “On the Natural Gas Market”, in practice, due to inherent market concentration, prevailing supply chain relations between incumbents and low awareness of customers, none of them were able to effectively benefit from such a right and to change their natural gas supplier. Thus, *de facto*, the regulatory effect of the CMU Resolution No 187 does not only encompass a guaranteed natural gas supply to the most vulnerable market segments, as an energy security and social protection measure, but also forecloses a defined market share for the benefit of incumbents and, consequently, sustains the market monopolisation. Based on the market data of 2016, the CMU Resolution No 187 secures the concentration of natural gas supplies covering approximately 67% of annual natural gas consumption in Ukraine.¹ As a result, over 2/3 of Ukraine’s natural gas retail market remains blocked from new market entrants and thus any possibilities for developed competition and liquidity therein are equal to none.

Notably, even if special obligations imposed on subjects of the natural gas market are aimed at pursuing the general public interest in line with Article 11(3) of the Law of Ukraine “On the Natural Gas Market”, the legitimacy of such obligations shall still be justified in terms of their proportionality, clear definition, transparency, non-discrimination and the least restrictive effect upon the natural gas market. Guaranteed supplies of natural gas to the most vulnerable of Ukrainian customers – household customers and religious organisations as well as heat producers serving households and religious organisations during the heating season, as a temporary measure until the internal natural gas market becomes competitive and liquid enough

¹ Report on activities of the National Commission for State Energy and Public Utilities Regulation of Ukraine of 2016, 30 March 2017, p. 111, graph 3.3.9.

to secure these customers without additional regulatory intervention, in principle may be seen as pursuing the general public interest of secure, stable and affordable supplies of natural gas as well as of heat and/or hot water of due quality. However, mere existence of a general public interest *per se* is not a sufficient legitimate basis for established obligations, especially those which trigger unsolicited concentration in the natural gas market and foreclose it from further developments. Based on well-established case law of the Court of Justice of the European Union, any public service obligation must be suitable to attain the objective pursued and, at the same time, may not go beyond what is necessary to achieve the objective in the general economic interest which it pursues. Concentration of natural gas supplies within market incumbents is clearly not necessary for ensuring secure and stable supplies to the most vulnerable customers in Ukraine.

In its Conditional Approval of 7 March 2017, the Energy Community Secretariat concluded that special obligations imposed by the CMU Resolution No 187 go beyond what is necessary to achieve the objective in the general economic interest which they pursue – *i.e.* guaranteed supply of natural gas to the most vulnerable market segments – and thus are not proportionate as well as lacking of transparency and legal certainty. It was consequently stated that the CMU Resolution No 187 could be considered as compliant with Article 11 of the Law of Ukraine “On the Natural Gas Market” and Article 3(2) of Directive 2009/73/EC only if non-compliances, legal flaws and shortcomings, as indicated by the Energy Community Secretariat in the Conditional Approval and followed-up in its letter of 21 March 2017, are rectified. Due to its failure to react accordingly, Ukraine remains in breach of its commitments under the Treaty establishing the Energy Community, and in particular to comply with mandatory requirements for public service obligations.

Considering the above, the draft Resolution proposes the adoption of a new wording of the Regulations on Imposing Specific Duties on Natural Gas Market Participants to Meet General Public Interests in Course of Natural Gas Market Performance which will replace regulatory measures enacted by the CMU Resolution No 187 and will ensure the pursuit of the general economic interest for secured natural gas supplies to the most vulnerable of final customers in compliance with mandatory requirements stemming from Article 11 of the Law of Ukraine “On the Natural Gas Market” and Article 3(2) of Directive 2009/73/EC. The draft Resolution also prescribes concrete measures for releasing the market concentration in non-regulated segments and for practical realisation of the customers’ right to choose and switch their suppliers.

2. Objective and means for the implementation thereof

The new Regulations, as proposed by the draft Resolution, aim at establishing temporary regulatory measures imposing special obligations on subjects of the natural gas market of Ukraine with an exclusive focus on secured natural gas supplies to the most vulnerable categories of customers and, at the same, defining the mandatory conditions which are expected to enhance the competition in and opening of the market, and effective realisation of the supplier switching right. In particular, the new Regulations propose:

(i) imposing subjects of natural gas market with special obligations to offer guaranteed supplies of natural gas to household customers and religious organisations as well as to heat producers serving households and religious organisations during the heating season at regulated conditions in pursuit of general public interests stipulated in Article 11(3)(1) and (2) of the Law of Ukraine “On the Natural Gas Market”;

(ii) establishing clear and transparent requirements for a competitive behaviour in non-regulated segments of the natural gas market, *i.e.* segments not covered by imposed special obligations, in line with Articles 3(1)(2) and (5), and 12 of the Law of Ukraine “On the Natural Gas Market”;

(iii) establishing additional measures for practical realisation of the customers’ right to choose and switch their natural gas suppliers in accordance with Articles 3(1)(3), 13(1)(1) and (2), and 14 of the Law of Ukraine “On the Natural Gas Market”; and

(iv) establishing instruments for effective monitoring and supervision of the compliance with the Regulations and proper implementation of regulatory measures introduced therein.

The new Regulations are proposed to come in force as of 1 January 2018 thus replacing the legal regime of special obligations currently imposed on subjects of the natural gas market under the CMU Resolution No 187, except for certain requirements which do not affect the exact performance of currently imposed special obligations and which demand for an immediate effect in order to ensure the implementation of market principles already enacted by the Law of Ukraine “On the Natural Gas Market” and to enhance the overall competitiveness in the market and its further developments.

Given a mandatory temporary nature of public service obligations, the new Regulations are proposed to remain in effect until 31 March 2019, *i.e.* by the end of the heating season of 2018/2019. Prior to the approach of the said date, the regulatory regime to be established by the new Regulations will have to be reviewed and reconsidered taking into account actual market developments until then.

2.1. Imposition of special obligations in the natural gas market

The new Regulations propose imposing the following two specific obligations on undertakings active in Ukraine's natural gas market: (i) the obligation of NJSC "Naftogaz of Ukraine" to offer natural gas during the heating season directly to heat producers which are essential for the maintenance of uninterrupted supply of heat and/or hot water to household customers and religious organisations, and (ii) the obligation of designated suppliers (*i.e.* incumbent regional suppliers) to offer natural gas supply services to household customers and religious organisations (Paragraph 4). Such proposed obligations to offer the supply of natural gas mean that designated natural gas undertakings – NJSC "Naftogaz of Ukraine" and regional suppliers – will be obliged to guarantee natural gas supplies to heat producers and to household customers and religious organisations respectively upon their request, but the latter will not be obliged to purchase natural gas exclusively from these suppliers and will be unrestrictedly allowed and provided with necessary information to switch to another preferred supplier which offers its services on the market.

Firstly, NJSC "Naftogaz of Ukraine" is proposed to be obliged to offer natural gas during the heating season directly to heat producers which are essential for the maintenance of uninterrupted supply of heat and/or hot water to household customers and religious organisations within a given district heating network. Comparing to the CMU Resolution No 187, the volumes of natural gas to be offered by NJSC "Naftogaz of Ukraine" to heat producers do not cover all categories of their natural gas use and are proposed to be limited to the exact volumes used for the production of heat and/or heating of the water supplied to household customers and religious organisations as well as used for the generation of electricity which is technologically inseparable due to combined production of heat and electricity (first and second indents of Paragraph 7). Remaining volumes of natural gas consumed by heat producers for any other operations, such as for commercial electricity generation, are not related to the pursued security and stability of heat and/or hot water supply to households and religious organisations during the heating season and thus shall not be taken into account for the purpose of guaranteed supplies of natural gas.

Eligibility of heat producers for guaranteed supplies of natural gas at regulated conditions as well as forecasted volumes of natural gas necessary to ensure the security and stability of their services to households and religious organisations during the heating season is proposed to be approved by the National Commission for State Energy and Public Utilities Regulation of Ukraine (hereinafter – NEURC) on the basis of the information and its justification provided by heat producers. Necessary approvals by NEURC are proposed to be made by 1 May each year (third and fourth indents of Paragraph 7). NEURC's approved list of eligible heat producers and natural gas volumes are envisaged as a basis for NJSC "Naftogaz of Ukraine" in forecasting, by 1 June each year, the volume of natural gas required for the upcoming heating season to form a natural gas resource for eligible heat producers (sixth indent of Paragraph 7).

In order to preserve legitimate interests of NJSC "Naftogaz of Ukraine" to get paid for supplied natural gas, it is proposed that NJSC "Naftogaz of Ukraine" shall be subject to this obligation to offer guaranteed supply of natural gas to heat producers only if occurring debts accumulated by eligible heat producers for natural gas supplied by NJSC "Naftogaz of Ukraine" in the previous heating season have been repaid or a debt repayment agreement was concluded or any other debt management measure introduced according to the conditions and procedures stipulated in the Law of Ukraine "On Measures for the Settlement of Debts for the Energy Resources Used by Heat Energy Producers and Centralised Water Supply and Sewage Operators" (seventh indent of Paragraph 7).

Special obligation to be imposed on NJSC "Naftogaz of Ukraine" shall be applied under the terms and conditions proposed by the new Regulation starting from 1 January 2018. Until then, regulatory measures enacted by the CMU Resolution No 187 shall remain in force.

Secondly, designated natural gas suppliers, *i.e.* regional suppliers listed in Annex 2 to the new Regulations, are proposed to be obliged to offer natural gas to household customers and religious organisations residing/placed within their respective service territory (*Oblast*), as defined by the area of licensed operations for the distribution of natural gas (first indent of Paragraph 8). As regards guaranteed supplies of natural gas to households and religious organisations, the new Regulations sustain the same supply model as currently enacted by the CMU Resolution No 187, except for newly elaborated conditions enabling the effective supplier

switching as explained herein below. Paragraph 8 of the new Regulations is proposed to come in force with immediate effect, *i.e.* on 1 September 2017.

Supply of natural gas to household customers shall be made based on a standard-form agreement approved in line with Article 12 of the Law of Ukraine “On the Natural Gas Market” (fifth indent of Paragraph 8). Currently, such agreement applies in a form approved by the NEURC Resolution No 2500 of 30 September 2015 (as further amended). The standard agreement is binding in case of all contractual relations for natural gas supply between a household customer and any supplier, *i.e.* in case of purchase of natural gas from the supplier with imposed special obligations or independent supplier.

And, *thirdly*, guaranteed supplies of natural gas required by the new Regulations are proposed to be offered by NJSC “Naftogaz of Ukraine” and designated suppliers at a price not higher than the price calculated in accordance with Annex 1 thereto (first indent of Paragraph 7 and first indent of Paragraph 8).

Annex 1 to the new Regulations provides a detailed mechanism for calculation of natural gas prices supplied to heat producers, household customers and religious organisations at regulated conditions within the scope of imposed special obligations. It is envisaged that the maximum price shall be calculated as a sum of a natural gas market price, *i.e.* a price for natural gas acquired by NJSC “Naftogaz of Ukraine” or designated suppliers on the market, a regulated price margin which for natural gas supplied by NJSC “Naftogaz of Ukraine” may not be higher than 1% of the acquired natural gas market price and for natural gas supplied by designated suppliers – than 1,5%, and natural gas transmission and distribution tariffs as set by NEURC under its adopted methodology (Paragraph 1 of Annex 1).

It is further proposed in Annex 1 to the new Regulations that, in any case, the price of natural gas supplied by NJSC “Naftogaz of Ukraine” and designated suppliers may not be higher than the price of natural gas at a level of import parity, including a regulated price margin and natural gas transmission and distribution tariffs. The formula for calculation of the natural gas price at a level of import parity is provided in Paragraph 2 of Annex 1.

It is also proposed that maximum price of natural gas calculated under Annex 1 to the new Regulations shall be announced on the official website of NEURC and shall be adjusted by NEURC by necessity at least on quarterly basis (Paragraphs 3 and 4 of Annex 1).

2.2. *Competitive behaviour in non-regulated segments of the natural gas market*

Apart from proposed special obligations regarding mandatory offers for the supply of natural gas at regulated conditions to heat producers, household customers and religious organisations, as explained hereinabove, the new Regulations do not envisage any other regulatory measures which would divert from market-based relations among subjects of Ukraine’s natural gas market.

Comparing to the CMU Resolution No 187, the new Regulations do not envisage any preferential treatment of NJSC “Naftogaz of Ukraine” and regional suppliers in purchasing natural gas necessary for carrying out the imposed special obligations. Further developments of the natural gas market require for market-based wholesale operations where all market participants have equal rights to acquire natural gas from domestic producers, importers and/or wholesale sellers. Market-based purchase of natural gas, after the full entry in force of the new Regulations (*i.e.* from 1 January 2018), shall be therefore mandatory also to NJSC “Naftogaz of Ukraine” and designated suppliers with no preferences or exemptions (Paragraph 5). It is further proposed to establish expressly that NJSC “Naftogaz of Ukraine” is no more entitled to any preferential treatment when purchasing natural gas from domestic producers of natural gas which are directly or indirectly controlled by the State, *i.e.* PJSC “Ukrigasvydobuvannya”, PJSC “Ukrnafta” and PJSC “Chornomornaftogaz” (eighth indent of Paragraph 7), meaning that currently applicable priority off-take of natural gas granted to NJSC “Naftogaz of Ukraine” is proposed to be abolished as unproportionate, market restrictive and discriminatory.

It is also proposed to envisage that NJSC “Naftogaz of Ukraine” has its own disposition in carrying out substitution operations between the domestically produced and imported natural gas in order to take into account the seasonal gaps between the usage and production of natural gas (ninth indent of Paragraph 7), thus eliminating any preferential treatment of domestically produced natural gas *vis-à-vis* imported natural gas, or *vice versa*.

Furthermore, in case NJSC “Naftogaz of Ukraine” will enter the retail market and start supplying natural gas directly to household customers, it is proposed to envisage that NJSC “Naftogaz of Ukraine” is considered

a regular supplier not enjoying any preferential treatment or subject to specific duties on the retail markets (eighth indent of Paragraph 8).

The competitive behaviour by subjects active in the natural gas market of Ukraine is proposed to be monitored by NEURC, in cooperation with the Antimonopoly Committee of Ukraine (hereinafter – AMCU), with clearly assigned regulatory powers as explained herein below.

2.3. Realisation of the customers' right to choose and switch the supplier

Unrestricted customers' right to freely choose and switch their natural gas suppliers, irrespective of any public service obligations imposed, is one of the fundamental criteria legitimising the imposition of such obligations. This means, in practice, that any customer which enjoys the guaranteed supply of natural gas under the established scheme of public service obligations may unrestrictedly opt for independent supplies and switch to any other supplier if its service offer seems more favourable and, equally so, such customer may opt back for guaranteed supplies at any time if independent suppliers active on the market are not able to provide more favourable service offers.

Terms and conditions for the supplier switching are already elaborated in Article 14 of the Law of Ukraine “On the Natural Gas Market” and in the Rules on the Supply of Natural Gas adopted by NEURC (Resolution No 2496 of 30 September 2015, as further amended). However, due to inherent market concentration in those segments covered by the scheme of special obligations currently established by the CMU Resolution No 187, existing supply chain relations, foreclosed entrance of new market players, and low awareness of customers, the supplier switching among heat producers, household customers and religious organisations is not happening in practice or, if such intentions arise, effective realisation of the switching right is obstructed by incumbent market forces and claimed uncertainties in the regulatory regime. Therefore, the new Regulations aim at introduction of additional mechanisms to ensure the ability for practical realisation of the supplier switching right.

Firstly, any customer eligible for guaranteed supplies of natural gas shall be allowed to choose and switch to its preferred supplier without any restrictions as well as any supplier shall be free to offer its services to such customers (second and fourth indents of Paragraph 2).

Secondly, heat producers shall not be obliged to purchase natural gas from NJSC “Naftogaz of Ukraine” exclusively and shall be allowed to switch to another supplier available on the market pursuant to the conditions stipulated in the Law of Ukraine “On the Natural Gas Market” and the Rules on the Supply of Natural Gas (fifth indent of Paragraph 7), including mandatory final settlement with the previous supplier (Article 14(2)(1) of the Law).

And, *thirdly*, as regards supplier switching by household customers and religious organisations, the new Regulations provide for a number of clarified mechanisms which aim to ensure the transparency of the supplier switching process. This includes the customer's right to change its supplier free of charge, penalties or any other obstacles (third indent of Paragraph 8), the obligation of distribution system operators to provide all data on consumption and consumers within their service territory (*Oblast*) to any other supplier, besides designated suppliers, upon their request, without costs and within a delay of not more than four weeks, in line with the applicable legislation on data protection (fourth indent of Paragraph 8), NEURC's competence to establish a common data format and non-discriminatory and transparent procedure for the provision of such information (fourth indent of Paragraph 8), NEURC's competence to adopt, upon consultation with AMCU, additional measures to ensure that suppliers and new market entrants can effectively enter the market of retail supply to all customers throughout the whole territory of Ukraine and that all customers are entitled to have their natural gas provided by the supplier of their choice regardless of their residence (sixth indent of Paragraph 8), and NEURC's competence to create and install on its website a calculator enabling comparison between the offers of all natural gas suppliers in Ukraine (seventh indent of Paragraph 8).

Provisions of the new Regulations stipulating the supplier switching rules are proposed to come in force with immediate effect, *i.e.* on 1 September 2017.

2.4. Monitoring and supervision competences

In order to ensure that all market participants enjoy equal access to natural gas produced by domestic producers, that independent producers of natural gas enjoy equal access to customers, and that new market entrants do not face any obstacles to enter the wholesale market for natural gas in Ukraine, NEURC, acting within its scope of competence assigned under the Law of Ukraine “On the National Energy and Public Utilities

Regulatory Commission” and the Law of Ukraine “On the Natural Gas Market”, is proposed to be entitled to monitor the contracts on the sale and purchase of natural gas concluded by any market participant with state-controlled domestic producers of natural gas, *i.e.* PJSC “Ukrigasvydobuvannya”, PJSC “Ukrnafta” and PJSC “Chornomornaftogaz” (first indent of Paragraph 6).

NEURC is also proposed to be assigned with a competence, upon consultation with AMCU and the Energy Community Secretariat, to establish the rules and ensure that anti-competitive conduct, such as insider information and market manipulation, is prohibited and effectively remedied in the wholesale market for natural gas in Ukraine, including its regulatory power to introduce the remedying measures allowed by the applicable legislation (second indent of Paragraph 6).

As regards natural gas supply relations at the retail level, NEURC is proposed to be entitled to monitor the development and necessity of regulated natural gas prices for household customers and religious organisations calculated under the formula provided in Annex 1 to the new Regulations, and suggest amendments should further price regulation be seen as no more justified (second indent of Paragraph 8), to monitor the realisation of the supplier switching right (third indent of Paragraph 8), and to monitor the market position and conduct of NJSC “Naftogaz of Ukraine” in retail markets, including NEURC’s regulatory power to impose additional measures protecting competition, upon consultation with AMCU and the Energy Community Secretariat, once NJSC “Naftogaz of Ukraine”, solely or collectively with other market participants, becomes dominant on any retail market (eighth indent of Paragraph 8).

Furthermore, in implementing imposed special obligations, individual natural gas undertakings – NJSC “Naftogaz of Ukraine” and incumbent regional suppliers – 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 Article 18 of the Treaty establishing the Energy Community. Therefore, the new Regulations propose to task AMCU with the competence to monitor and report the implementation of imposed special obligations from the perspective of State aid (Paragraph 10).

3. Legal aspects

The draft Resolution is proposed for adoption in accordance with Articles 11, 12 and 14 of the Law of Ukraine “On the Natural Gas Market”. The draft Resolution will repeal the CMU Resolution No 187.

Adoption of the draft Resolution may require for subsequent amendments to regulations adopted by NEURC, AMCU and/or other authorities in charge.

4. Financial and economic rationale

Implementation of the draft Resolution will not require for additional financial expenses from the state budget.

5. Position of stakeholders

The draft Resolution requires for its adjustment with the [Ministry of Finance of Ukraine, Ministry of Economic Development and Trade of Ukraine, Ministry of Justice of Ukraine, NEURC, and AMCU].

The draft Resolution shall be consulted with the Energy Community Secretariat.

6. Regional aspects

The draft Resolution is not related to the questions of the development of administrative and territorial units of Ukraine. The special obligations to be established by the draft Resolution shall not apply to natural gas suppliers and customers residing/placed on the temporarily occupied territory of Ukraine.

6¹. Prevention of discrimination

The draft Resolution contains no discriminatory provisions. The draft Resolution also eliminates discriminatory provisions currently enacted by the CMU Resolution No 187.

7. Prevention of corruption

The draft Resolution contains no rules or procedures that would favour corruptive offences.

8. Public debate

The draft Resolution has been made public on the official website of [the Ministry of Energy and Coal Industry of Ukraine] for public debate.

9. Position of social partners

The draft Resolution does not require for approval from social partners as it is not concerned with the labour relations.

10. Estimation of regulatory impact

The draft Resolution is a regulatory act. Analysis of the regulatory impact has been made public on the official website of the [the Ministry of Energy and Coal Industry of Ukraine] for further comments and proposals from legal entities and individuals.

10¹. Impact on labour market

Implementation of the draft Resolution will not affect the labour market.

11. Estimated results

Adoption and implementation of the draft Resolution will ensure the pursuit of the general economic interest for secured natural gas supplies to the most vulnerable of Ukraine's final customers – household customers and religious organisation as well as heat producers serving households and religious organisation during the heating season – in compliance with mandatory requirements stemming from Article 11 of the Law of Ukraine “On the Natural Gas Market” and Article 3(2) of Directive 2009/73/EC. The draft Resolution will also ensure the enactment and enforcement of concrete measures for releasing the concentration in non-regulated segments of Ukraine's natural gas market and for practical realisation of the customers' right to choose and switch their natural gas suppliers.

Minister of Energy and Coal Industry of Ukraine

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[●] August 2017