EUWI

EU WATER INITIATIVE

EAP Task Force

Document 24

Joint Meeting of the EU Water Initiative's EECCA Working Group and the EAP Task Force Environmental Finance and Water Networks

29 March –1 April 2005, Chisinau, Moldova

Local Credit Systems for Municipal Water and Environmental Infrastructure Ukraine Case Study

Draft

Participants are invited to take note of the document and to provide their comments on its content.

ACTION REQUIRED: For information, discussion, and endorsement.

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Acknowledgments

Inna Lunina, Financial and Budgetary Projections Department Head, Institute of Economic Projections, National Academy of Sciences of Ukraine, prepared a section of this case study on the issues of the current system of intergovernmental finance in Ukraine, provided the statistics on the subject and drafted recommendations with respect to intergovernmental finance, which are viewed as instrument that can help SNGs play a larger role in local capital investment.

At request of “Tariff Reform and Communal Services Enterprises Restructuring Program in Ukraine” funded by the United States Agency for International Development and implemented by PADCO, Inc./Ukraine, Ministry of Finance of Ukraine, Securities and Stock Market State Commission and the State Committee of Housing and Communal Services have provided statistics, presented in the Attachment 1 (Table 1, Table 4, Table 6, Table 7) and in the Attachments 2 - 4.

The views in this paper are those of the author of the paper and do not necessarily correspond to the views of any other party.

I. OVERALL DEVELOPMENT OF THE MUNICIPAL CREDIT MARKET

1. Municipal Credit Market Development Overview.

Ukrainian sub-national credit system for infrastructure development historically constituted a minor portion of the overall Ukrainian capital market. Except for a short-term financing, little borrowing is underway at the local level. Limited amount of available capital investment financing does not address capital needs of sub national governments (SNG)[1] and communal service enterprises (CSEs)[2]. The amount of municipal bonds issues constituted less than 1% of the overall securities issues, registered by the Securities and Stock Market State Commission (SSMSC) since 1995 until the end of 2002. Only individual examples of SNG commercial bank lending are known. Two corporate bond issues by CSEs have been used to attract financing for capital improvement in municipal services sector. As a result, essential municipal infrastructure and provision of services, such as water supply and treatment, wastewater collection and treatment, district heating, highways, education and health have been under financed.

Budgetary subsidies or tariff increases for the services provided to current system users cannot cover costs of complying with European Union standards for municipal service delivery, a requirement that comes from the tasks, set by the President of Ukraine in his address to the Supreme Council of Ukraine.[3] To meet such needs, the total capital investment requirements for the water supply and wastewater sector only have been estimated at EUR 22-26 billion[4] over the next 20 years[5]. EUR 4-6 billion of this amount correspond to urgent investments.[6] About 20% of water supply networks and 25% of wastewater collection networks require replacement. Approximately 40% of water treatment plants and water and wastewater pumping stations require rehabilitation and replacement of equipment[7].

SNG borrowing in Ukraine is considerably lagging behind general development trends of the overall financial markets due the factors, among which there should be highlighted the following: decentralization of central government powers[8] resulting in autonomy and strengthening of material and financial base of local self-governments[9], reforms in the system of intergovernmental finance[10], separation and defining of responsibilities of the central government

[1] In this report SNGs include executive and legislative bodies of Autonomous Republic of Crimea, oblasts, rayons, cities, rayons (districts) in the city, villages and residential settlements. *Local self-governments* (LSG) are governments of municipalities, villages and residential settlements. The rayon and oblast councils are LSG, which represent joint interests of territorial communities of the villages, residential settlements and cities. Executive powers in oblasts, rayons, rayons of Autonomous Republic of Crimea, rayons in the cities of Kyiv and Sevastopol are executed by oblast, rayon, Kyiv and Sevastopol *local state administrations* (LSA).
[2] Communal service enterprises are businesses, responsible for provision of specific municipal services, among which are water supply and wastewater, district heating, solid waste disposal, housing, public transport etc.
[3] Address of the President of Ukraine to Supreme Council of Ukraine "European Choice. Conceptual Basis of Economic and Social Development of Ukraine for 2002-2011".
[4] Exchange rate 1 EURO = 6.66 UAH (on January 30, 2004).
[5] State Budget of Ukraine revenues for 2004 are estimated at EUR 9.2 billion.
[6] COWI/DANCEE, Ukraine National Water Sector Strategy and Action Plan, Strategic Issues Report, September 2002. No similar sector studies have been recently carried out for district heating.
[7] COWI/DANCEE, Ukraine National Water Sector Strategy and Action Plan, Interim Report, June 2002.
[8] Constitution of Ukraine, Article 140. Chapter XI.
[9] Law of Ukraine„On Local Self Governments" No.280/97 –VR of May 21,1997 (with amendments).
[10] The Budget Code of Ukraine No. 2542 – III of June 21, 2001.

and local self-governments for execution of economic functions, including organization of local public service delivery, regulation, human resource management and control. Substantial legal and regulatory uncertainties regarding sub-national credit market operation that followed the changes that have been mentioned earlier became an impediment to the development of self-sustaining SNG borrowing. In the past, studies of capital market access strategies for SNGs and CSEs, conducted in Ukraine by IBRD, had revealed other key constraints to sub national access to long-term credit market on both the supply and demand side, some of which have been removed after the approval of the Budget Code of Ukraine in 2001 and other regulatory acts that followed it.

The latest research[11] of the SNG debt market development, conducted by the Ministry of Finance of Ukraine in support of the World Bank financed Municipal Development Loan Fund project (MDLF), indicated that Ukraine is currently in the process of setting essential elements of legal framework for a development of a particular loan program under the MDLF and a municipal credit market in general. These include not only drafting of new legislation and setting of regulatory framework but also amending of existing conflicting laws that affect SNGs powers to incur debt. The Urban Institute experts,[12] who prepared a report on legal and regulatory framework for sub-national borrowing in Ukraine, envisage the success of further SNG credit market development by building at a national level a legal and policy framework, supporting credit market operations, and accumulating practical experience at the local level that allows smoothing implementation of newly approved legislation.

The importance of the local (municipal) credit market in the total picture of overall economic development of Ukraine has currently been determined as a way to improving investments into economy that allow implementation of strategic economic and social goals of Ukraine in the next decade. In October 2003, Inter-Agency Working Group representing Government of Ukraine, International Donor Agencies, International Finance Institutions, and municipalities was created to assist in development and implementation of financing mechanisms of local development projects, which are expected to be carried out by local self-governments without provision of sovereign guarantees[13]. Prudent borrowing through commercial bank intermediaries is viewed to augment investment capacity of local self-governments and CSEs, enhance efficient use of energy and material resources in provision of public services in a market economy [14].

2. Principle Vehicles for Lending to Municipalities

In the past, three principal vehicles for lending to SNGs or CSEs had been available:

(1) lending from higher levels of government;
(2) lending by commercial banks;
(3) municipal and corporate bond issuing.

[11] "Ukrainian Municipal Development Loan Fund Project. Legal and Regulatory Framework for Sub -National Borrowing", prepared by the Urban Institute/M. DeAngelis, E. Korniychuk, Y. Gregirchak/ for Ukrainian Municipal Development Fund Projects, The Ministry of Finance of Ukraine (June 2002).
[12] See footnote 11.
[13] Decree of the Cabinet of Ministers of Ukraine "On Creation of the Inter-Agency Working Group on the Issues of Financing Mechanisms for Local Development Projects Without Provision of Sovereign Guarantees" No. 1608, October 20, 2003.
[14] "The National Program of Reforming and Developing Housing and Communal Economy for 2004-2010", Draft Law of Ukraine, in review by the Supreme Council of Ukraine since October 2003.

Historically, both bank loans and bonds have been competing with each other on cost basis. Until approval of the Budget Code of Ukraine in 2001, borrowing from higher levels of government have not been built on the principles of hard credit culture and effectively resulted in subsidization of local budgets by the state. The Budget Code set new rules regarding this type of bowing by prohibiting short-term lending from one budget to another.[15]

Currently, sub national borrowing market features several kinds of debt instruments:

(1) State credits, borrowed from international development organizations or International Financial Institutions;
(2) commercial bank loans;
(3) municipal and corporate bonds;

These debt instruments are offered on a competitive basis by respective intermediaries to sub national governments, which are principal administrative and territorial units where *local self-government* and the *powers of Autonomous Republic of Crimea* are exercised. Pursuant to the Budget Code of Ukraine (2001) only Verkhovna Rada of Autonomous Republic of Crimea and city councils have right to borrow. Utilities (CSEs) that provide municipal services also have direct access to the local debt market.

2.1 On –lending to Municipalities Through State Credits

State credits, borrowed from International Financial Institutions, such as IBRD and European Bank for Reconstruction and Development (EBRD), have recently become the source of long-term financing for municipalities and their respective CSEs, providing project financing in the area of water supply, wastewater and district heating. Pursuant to the Decree of the Cabinet of Ministers, in 2003, Ukrainian Municipal Development Fund[16] have been established as a result of an agreement between the Government of Ukraine and IBRD that was reached under MDLF project with the purpose to support socially important projects of local self governments in the cities.

Four long - term loan agreements have been concluded by IBRD and EBRD with the Government of Ukraine and one with municipality of the city of Zaporizhzhya for infrastructure finance purposes. IFI's loan funds are providing project financing in the area of water supply, wastewater and district heating in the cities of Zaporizhzhya, Lviv and Kyiv (For details on State direct and guaranteed debt outstanding, see Attachment 4, Table 1,2). A credit line for municipalities of Donetsk, Luhansk, Lviv and Volyn oblasts have been provided with IBRD funding to soften social impacts of reforms in coal industry where coal mines are shutting down and infrastructure objects are transferred from the state to municipal ownership (For details, see Attachment 1,Table 1). EBRD is negotiating three loan agreements with the cities of Kherson, Dnipropetrovsk and Luhansk for implementation of projects in water and wastewater sector.

Standard terms for IBRD and EBRD loans so far have included a requirement for provision of sovereign guarantee and co-financing on the part of the borrower. At the same time, EBRD

[15] Article 73.
[16] Decree of the Cabinet of Ministers of Ukraine "On Creation of Ukrainian Municipal Development Fund" No. 1101, July 2003.

would prefer direct lending to municipalities; however, perceived absence of reliable security for large amount loans at municipal level (excluding Kyiv) is viewed as an obstacle for direct lending to the SNGs at this stage of local credit market development.

In addition, EBRD has required private sector participation and availability of financing that is provided either by the borrower or the owner of the utility, the latter might be reaching 30% of the overall project-financing requirement. EBRD promotes PSP in any form, which can be realistically applied: either participation of a corporate partner (performing consulting services), or through conclusion of a management or concession contract. Further, EBRD requires that tariffs should be set at full cost recovery level, including debt service. If the tariffs do not recover full cost of service, there should be a developed schedule of required tariff increases.

Given the above, a very limited number of municipalities and CSEs can get access to the funding of these Financial Institutions, due to the high scale of projects that can be financed from these sources, and the limitations that arise from current requirements of World Bank and EBRD to provide sovereign guarantees for the loans.

2.2 Commercial Bank Loans to SNGs and CSEs

Although various kinds of debt instruments have been available at the market since early 90s, practically no long-term credit resources have been attracted for financing of capital projects, while short-term credits have been continuously providing a source of short-term liquidity to SNGs and CSEs.

At the same time, ten-year development of the overall commercial bank credit market reveals trends in the shift in banks' credit portfolio structure from short-term to long-term lending. National Bank of Ukraine classifies short-term loans as one-year loans, and long-term ones are those, which are extended for more than one year. Since 1993, portion of overall long – term bank lending was steadily growing. From 3% of total loans, extended in 1993, it increased to 28% of total UAH 42.035 billion of loans extended by commercial banks into Ukrainian economy by the end of 2002 (For details, see Attachment 1,Table 5).

These tendencies in the banking sector are reflecting growth of Ukrainian economy over the last three years, stable monetary unit of Ukraine, decreasing interest rates and improved banking regulation.[17] Most banks report that the quality of the loan portfolio has been steadily improving during 2002 and 2003, with average share of bad loans for 10 largest banks dropping to average of 6% in August 2003 in comparison with 13% at the end of 2002[18].

Despite steady strengthening of the banking sector since 2000, easing of the minimum reserve requirements, drop of interest rates and respective increase in lending to the real sector of economy, the level of banking sector involvement in the real economy remains low. Deloitte's assessment of the ratio of loans to GDP for 2003 has been expected to reach only 23% or USD 13.4 billion[19].

[17] "Financial Condition of Ukrainian Banks in the First Half of 2002 and Ways to Improve Their Performance", by V. Krotiuk, O. Kireev, G. Karcheva, NBU.
[18] "Ukrainian Banking Study", Deloitte, 2003.
[19] "Ukrainian Banking Study", Deloitte, 2003.

2.3 Municipal Bonds

Sub-national governments' experience with municipal bond issues, occurring between 1995 and 1998, is considered an exception specific to the Ukrainian SNG mid - to long-term debt market development since 90s. It is characterized by the surge of municipal bond issuance activity in 1995 – 1998 and fast ending after the Odessa city UAH 61 million[20] bond default took place in 1998. Presidential Decree[21] that followed the default introduced legal restrictions for municipal long-term borrowing and effectively stopped municipal bond market development causing municipalities to give preference to borrowing from the banks, which have become less restrictive.

Municipal bond market has been inactive until November 2003, when for the first time since 1998, the Securities and Stock Market State Commission (SSMSC) registered a new municipal bond issue of the city of Kyiv. As of January 2002, amount of municipal bond issues constituted less than 1% of overall securities issues, registered by the SSMSC since 1995 (For details, see Attachment 1, Table 2 and Attachment 2, Table 1), reflecting very low use of debt securities by the municipalities.

For example, the Government of Ukraine, increased reliance on T-bills with 2-5 year maturities since 2002, which is indicative of

2.4 Corporate Bonds

During all period of corporate bond market development only two projects in municipal services sector have been financed through corporate bond issues. In 2002, as reported by the SSMSC, one State-owned solid waste collection and disposal company "Ukrecocomresurs" placed two bond issues with 10-year and 20-year maturities for total nominal value of UAH 100 million. One municipally owned CSE had issued corporate bonds for rehabilitation of the district heating system[22]. No other corporate bond issues for the infrastructure development purposes have been registered with the SSMSC so far, representing very low level of activity of the CSEs at the corporate debt securities market.

At the same time, during 2002 alone, SSMSC registered 108 corporate bond issues for the amount of UAH 4.3 billion, which exceeded the amount of total corporate bond issues for 1996 - 2001 by more than 4 times[23]. This statistics is indicative of sharp increase in the development of the corporate bond market, the trend that is expected to be maintained with the development of the market of institutional investors, such as mutual finds and non-state pension funds and improved legislation on corporate bond issuance, which was enacted by the Decision of SSMSC No.322 "On Approving Regulation on the Procedure of Corporate Bond Issues" (July 17, 2003).

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[20] Nominal value of the bond issue.

[21] Presidential Decree "On Procedure for External and Internal Borrowings Performed by Local Self-Government" No. 655/98 of June 1998.

[22] In 2003- Jan. 2004, Kherson Telplokomunenergo (Kherson Heat Supply Company) issued four series of corporate bonds for total value of UAH 10 million.

[23] For 1996-2001 total amount of registered corporate bond issues was UAH 1.03 billion (SSMSC. http://www.ssmsc.gov.ua/4/2002/2.2.2.1.shtml)

3. Sources of Credit: interest rates, tenor of loans, institutional arrangements

Bank lending and municipal bond issuing have been major lending instruments available to municipalities and their CSEs during the last decade. Until 1998, both forms of debt have been utilized by the SNGs, showing that from the legal and economic point of view Ukraine had no reason to favor one form of lending over the other. The Odessa bond default on the first payment date for the bonds and the risks related to borrowing by SNGs, which became clear after the default, revealed the need for improving legal framework that is required for credit market development at the level of sub-national governments, especially with respect to issuing of debt securities. Lack of potential investor’s trust to Ukrainian legislation related to the SNG borrowing has created obstacles for further development of the municipal bond market and slowed down its development until Budget Code approval in 2001.

Currently, in terms of cost, relative interest rates, tenor of loans, institutional arrangements, and other important considerations, such as partnership relationship going beyond lending to include technical assistance in project preparation bonds and bank loans have some distinctions.

3.1 SNG Bonds

Some experts believe that bond issuance may have some benefits to SNG because it is not mandatory to secure debt with liquid assets, and municipality still has an ability to diversify sources of debt financing by obtaining loans.

However, procedure for municipal bond issue is more complicated than with the commercial bank loan: it requires extensive legal support, mandatory engagement of the financial intermediary to organize the issue, it may also require higher interest rate payment as compared to the terms offered by the banks, which until 2004 could maintain SNGs operating accounts (see comments in 3.2).

Publicly offered bonds were favored by the SNGs during 1995-1998 due to the lack of defined legal provisions on key positions and absence of formal registration of the issues with the SSMSC. This has become a strong precondition for growth in the volume of issues by the SNGs as compared to commercial mid- and long-term lending. In 1996 interest rates on commercial loans were reaching 80% per annum (see Table 2) vs 65% on bonds. However, currently, it is hard to find significant difference between two instruments with respect to interest rates or tenor of loans (Table 1).

The latest municipal bond issue of the City of Kiev had the following features: Kyiv City municipal bond is a term bond with principal amount due at maturity, while interest payment is made every three months. There are 20 interest payment periods, with determined interest rates: 1st – 4th interest period – 14% p.a.; 5 - 8 $^{th\ th}$ – 13% p.a.; 9 -12 $^{th\ th}$ – 12% p.a.; 13 - 20 $^{th\ th}$ –1.5 of the NBU discount rate but no less than 10% and no more than 14% p.a.

Table 1. Municipal Bond Maturities and Terms of Compensation

Period	**Tenure of Bond (in months)**	**Compensation, interest p.a.**
1996	3 – 66	Up to 64,8%

Period	Tenure of Bond (in months)	Compensation, interest p.a.
		annual interest on face value
1997	12 – 13.5	50%
1998	12	25-30%
1999	-	-
2000	-	-
2001	-	-
2002	-	-
2003 (September)	60	14%- 12%

Source: SSMSC

3.2 Bank Lending to SNGs

Bank lending to SNGs is realized within the framework of standard commercial banking. There are no special municipal banks in Ukraine. This means that municipalities and their utilities are exposed to savings and lending horizons, offered at the overall commercial debt market on a competitive basis and no subsidized lending programs are available. Table 2 represents data on the weighted average annual interest rates, offered by the commercial banks since 1996 until 2003 on credits and deposits in national currency.

Table 2. Commercial Bank Annual Interest Rates
on Loans and Deposits in National Currency

Period	Deposits	Loans
1996	34.3	77.0
1997	18.2	49.1
1998	22.3	54.5
1999	20.7	53.4
2000	13.5	40.3
2001	11.2	31.9
2002	7.8	24.8
2003 (September)	6.7	17.2

Source: NBU (For details, see Attachment 1, Table3)

Historically, borrowing from commercial banks has been utilized by oblasts and cities of medium size. Cash deficit financing was the primary reason of borrowing by the SNGs. Banks, which were holding current accounts of the respective governments, were lending short-term funds to their sub national clients without performing any kind of creditworthiness analysis. The banks used to manage municipality’s financial accounts and maintain the municipality’s deposits. These allowed the banks to become familiar with the financial affairs, needs of their SNGs clients and set basis for mutually beneficial relationship. As a result, some commercial banks are building their relationship with the clients on the principles of municipal bank philosophy, e.g Bank “Khreschatyk” that offers all spectrum of financial services to the City of Kyiv Administration, among which are financial consultation services, underwriting, municipal bond issue organization services and many other.

Pursuant to the Budget Code[24], since 2002 the Sate Treasury has started executing both the revenue and expenditure (since 2004) side of the local budgets. Some experts and SNG financial managers envisage that this restriction of the Budget Code will become an impediment in the development of the local debt market by inhibiting the willingness of the banks to lend to SNGs.

3.3 Bank Lending to CSEs

Until 1990, CSEs were obtaining state funding for capital investment. Although the situation have changed due to the lack of State budgetary financing, CSEs have continued looking to the State and the municipality for financing and in only a small number of cases have sought to borrow from commercial banks, which resulted in the relative absence of demand and lending activity to the CSEs.

At the same time, recently demand on the part of CSEs for bank loans has started to increase. Many CSEs realize that no funds will be transferred from the State, unless it is a case of emergency, and little financing can be expected from the municipalities. They understand that the best way to mobilize financing for capital investment is to borrow it from banks.

PADCO, Inc., implementing US AID financed “Tariff Reform and Communal Services Enterprises Restructuring Program in Ukraine” project, observed that while two or three years ago CSEs routinely expressed lack of interest in borrowing at 27- 30% interest from commercial banks, chief economists and directors are increasingly likely to compare those interest rates to the financial internal rates of return of energy-saving capital investment projects, which are often higher than 30%. Enterprises understand better and better the potential value of commercial loans for the financial performance of their enterprises. Selected data on CSE borrowing in 25 oblast centers (Table 3) indicate that only 20% of oblast center utilities have been utilizing commercial loans for financing their operating or investment activity. Available data also shows a shift in borrowing from short-term to longer-term loans attracted for capital investment since 2002 (For details, see Attachment 1, Table 4).

Table 3. Bank Lending to CSEs
in the Oblast Centers of Ukraine, 1996-2003

Period	**City**	**Short - term loans, annual interest rate**	**Long - term loans, annual interest rate**	**Long - term loan term, years**
1996				
1997	Cherkasy	no interest		
	Ivano-Frankivsk	60%		
1998 -1999	Ivano -Frankivsk		75%	3
2000	Mykolaiv	30%		
	Donetsk	35%		
	Zaporizhzhya	36-35%	Libor +1%*	15
	Lviv	28%		
2001	Mykolaiv	27%		
	Donetsk	24-30%		

[24] Article 72-14

Period	City	Short - term loans, annual interest rate	Long - term loans, annual interest rate	Long - term loan term, years
	Ivano -Frankivsk		33%	1.5
	Kherson		18%	2
	Khmelnytsky	29 - 20%		
	Zaporizhzhya	36 – 7%	Libor +1%	15
	Lviv	30%		
2002	Mykolaiv	18%	18%	3
	Donetsk	20-25%		
	Ivano -Frankivsk		28%	3
	Khmelnytsky	20-18%		
	Lviv	28 -20%		
	Zaporizhzhya	36 – 7%	Libor +1%	15
2003 (September)	Mykolaiv		17%	5
	Chernivtsy		23%	3
	Zaporizhzhya	14,6 - 11%	Libor +1%	15

Source: State Committee on Housing and Communal Services of Ukraine, January 2004

* Interest rates for Zaporizhzhya indicate terms of the long-term loan in foreign currency with EBRD for water wastewater project.

3.4 Corporate Bonds

Corporate bond market in the public sector has not been developed at all. No corporate bonds have been issued by the communal utilities until 2002 for the purposes of municipal infrastructure development. The first corporate bond issue for this purposes occurred in 2002, when State-owned solid waste collection and disposal company “Ukrecocomresurs” placed two bond issues (see section 2.4 of this report).

The second corporate bond issue took place in July of 2003, when municipally owned Kherson Heat Supply utility placed the first series of one-year bonds at 14% annual interest rate. Nominal value of four consecutive series of bond issues is UAH 10 million. Interest payment comes due at maturity of each series.

Kyiv based investment company became a lead manager for the issuer. The city of Kherson showed preference to the short-term bond issue over commercial lending due to absence of a mandatory requirement to pledge physical property as collateral. In the legislation, the provision for issuance of an asset-backed bond is an optional one. Backed bonds are called “additionally backed bonds” and assume that issuer liabilities are partially or fully backed by the insurance company or the guarantor.

The managers of Kherson Heat Supply utility preferred issuance of corporate bonds to bank lending because they can place an issue with big employers in the city, employees of which are customers of heat supply utility. One of such employers has outstanding accounts payable on salaries to its employees; consequently, the employees cannot pay for communal services. Heat supply utility believes that by placing the corporate bond with this corporate client it will solve a problem with non-payment of communal services by the employees of the corporation, who will be able to offset debts for heat services with the utility through corporate bonds, initially purchased by their employer. This example shows one of the ways, in which Ukrainian CSEs are trying to find solutions to investment financing problems.

In order to issue corporate bond, the Kherson Heat Supply utility had to undergo financial and technical audit, which had not to be performed under standard commercial bank lending, and paid for the services of the lead manager. The city preferred not to be debt issuer because it had to obtain approval for debt issuance from the Ministry of Finance and obtain credit rating. In this respect, corporate bond issue by the CSE allowed the city to obtain financing for capital investment in shorter period of time as compared to financing through a municipal bond issue (For comparison of corporate and municipal bond features see Table 4).

4. Security for SNG Debt

Ukrainian legislation distinguishes several types of security that can be offered to lenders by the SNGs:

(1) collateral: pledges of physical assets, general obligation, pledges of future revenues;
(2) guarantees.

4.1 SNG Collateral

Collateralized lending, secured by municipally owned physical assets, is the most common type of security. Banks are mostly familiar with this type of collateral and have established procedures for documenting this type of security. Current experience with loan collaterals indicates that the ratio of collateral value to the loan amount varies from 2 to 5, depending on the negotiations with the lender and borrower's risk assessment[25]. For most SNGs, it is favorable to see diminishing of the value of physical property as collateral, since the ability of local governments to pledge suitable for transfer to the private sector municipal assets is limited, and continue to be reduced. From the point of debt market development, reliance on physical asset collateral distracts attention from a project underlying financing, and holds up SNGs from gaining experience with project costs and benefits analysis and development of SNG finances.

General obligation borrowing, secured by general obligation of the municipality to pay from the SNGs budget funds, is less common, because lenders are concerned whether the subsequent SNG administrations will honor commitments made by a prior council. So, this type of security is mostly used for short-term borrowing. However, lender's concern appears to be more of market perception rather than legal imperfection, since the Budget Code requires municipalities to include both interest and principal obligations in the budgets. When longer term lending becomes a practice, this issue may not be of a concern.

Until 2004, lenders could require that municipal borrowers maintain their operating accounts with the bank so that they could automatically withdraw any loan payments due. However, such form of guarantee will no longer be utilized and available to the lenders, because State Treasury

[25] Resolution of the Board of the National Bank of Ukraine "On Approval of the Regulation on the Order of Setting and Using Reserve for Recovery of Potential Losses on Banks' Credit Operations" No.279 of July 6, 2000 sets forth regulatory preferences for collateral, which is taken in account for determining amount of reserve to compensate for credit risk of a particular borrower.

started execution of revenues and expenditure side of the budget and municipalities keep all the accounts with the Treasury.

Since borrowing authority is limited only the cities and Council of Autonomous Republic of Crimea, local state administrations are not allowed to use state property or property of local self-governments, which is operated by the local state administrations, as collateral or any other type of security[26].

4.2 SNG Guarantee

The Budget Code provides that an SNG may act as a guarantor with respect to the loans of legal entities, which are owned by the community. Local council has the right to authorize inclusion of guarantees within permitted limits in the respective local budget, and executive bodies are authorized to issue guarantee within such limits. Such provision gives more power to the executive bodies than with the authorization of debt, since only local councils have the right to authorize debt issuance. Nevertheless, the Law on the State Budget for 2003 and the State Budget for 2004 do not allow enacting this provision, disallowing SNGs from issuing guarantees. Additionally, pursuant to the newly enacted Civil Code of Ukraine (2004), only financial institutions or insurance companies may issue guarantees[27] and pursuant to the Budget Code a guarantee may be issued subject to a counter-guarantee, the meaning of which is not yet clearly defined.

Concerns regarding lack of clarity in the provisions of the Codes with respect to issuance of guarantees have not yet developed (exception is lending by IFIs) since there has been little lending and mostly for short maturities. However, it is expected that existing legal framework for guarantees will have to be amended to incorporate necessary elements. Government of Ukraine currently acts as a guarantor with respect to the loans granted to the government of Ukraine and to individual municipalities by the International Financial Institutions for the purposes of financing municipal infrastructure development projects (see Attachment 1, Table 1).

4.3 Transfer Intercepts

Transfer Intercepts of State Budget Transfer Funds are not legally authorized in Ukraine due to absence of the relevant provisions in current legislation. The issue of establishing intercept form of security for SNG debt has been discussed by various expert groups, which believe that such mechanism can be effectively utilized in Ukraine by the cities that receive State Transfer Funds. However, proper intercept provisions should be drafted carefully allowing credit market development and not becoming subject for abuse by the local governments.

4.4 CSEs Debt Securing

Pursuant to the National Bank’s requirements, bank loans granted to the CSEs or any other borrower have to be secured. Loan collateral in the form of municipally owned property or assets owned by municipal enterprise is the most typical type of security accepted by the banks. Since most CSEs in Ukraine are fully owned by their respective municipalities, they are not able to use

[26] Law of Ukraine “On Local State Administrations” No. 586-XIV of April 9, 1999. Article 15. Chapter III.
[27] Civil Code, Article 560.

their fixed assets as collateral on bank loans without approval of the city council. Bank collateral requirements can be up to five times the value of a loan.

Securing loan with physical assets is a challenging issue for Ukrainian CSEs, since present legal framework on privatization[28] prohibits alienation of property rights for communal services infrastructure. At the same time, such laws as the Law "On Local Self-government" and the Budget Code, support the municipality's right to use its property as loan collateral. Assets, which can easily be transferred to the third parties, such as municipally owned buildings, are commonly used type of loan security. As a result, the legal framework is quite controversial and some treat current legislative provisions in the way that with the city's support, the enterprise can put up selected facilities such as pumping equipment or boiler houses as collateral for loans should the commercial bank accepts this type of collateral.

The procedure for documenting the CSE's ownership of these facilities is quite complicated, and includes several steps that the CSE has to make. This process includes the following key steps: obtaining of the permission of the City council to pledge specific property as collateral, attesting to the enterprise "commercial management rights" to said property and obtaining by the CSE the "Certificate of Ownership" for said property.

Latest selected statistics from the oblast center cities that was gathered by the SCHCS of Ukraine in January of 2004, indicated that some utilities pledged revenues as repayment of one-year loans, or accounts receivable. Such utilities had 3 to 5-year positive prior credit history, which permitted them obtaining of such loan terms. In addition, loans were short-term, which allowed lenders making projections of the cash flows of the utilities and conduct risk assessment with great degree of certainty. This shows that CSEs have problems with securing debt both with physical assets, which are mostly infrastructure objects that can not be alienated, or with revenue pledge for longer than one year term due to absence of revenue predictability (For details, see Chapter II, section 3 of this report).

5. SNG Authority to Borrow. Restrictions on the Issuance of Debt.

In Ukraine, numerous legal provisions govern SNG borrowing. The Budget Code of Ukraine[29], The Law of Ukraine "On Local Self-government"[30], The Law "On Securities and Stock Market"[31], Presidential Decree "On Procedure for External and Internal Borrowings Performed by Local Self-government" [32], the Resolution of the Cabinet of Ministers "On Approval of Procedure for Borrowing to Local Budgets"[33], Regulation of the Securities and Stock Market State Commission " On Procedure for Internal Municipal Bond Issues" [34], are those legal

[28] Law of Ukraine "On Privatization of State Property" No. 2163-XII of March 4,1992(as amended), Article 5.
[29] The Budget Code of Ukraine, No. 2542-III of June 21, 2001.
[30] Law of Ukraine "On Local Self-Government", No. 280/97-VR of May 21, 1997 (as amended).
[31] Law of Ukraine "On Securities and Stock Market" No. 1201- XII of June 18, 1991 (as amended).
[32] Decree of the President of Ukraine "On Procedure for External and Internal Borrowings Performed by Local Self-government" No. 655/98 of June 18, 1998.
[33] Decree of the Cabinet of Ministers No. 207 of February 24,2003.
[34] SSMSC Decision No. 414, October 7, 2003 (cancels Resolution "On the Procedure of Issuance and Circulation of Local Bonds", brought into force by Resolution No.48 of the Securities and Stock Market State Commission on October 13, 1997.

documents, which can be viewed as key building blocks in the process of creating an improved system of intergovernmental finance and implementation of intergovernmental decentralization.

The Budget Code is a primary document, setting principle provisions regarding SNG authority to borrow and restrictions on debt issuance:

- Supreme Council of the Autonomous Republic of Crimea and the city councils are allowed to borrow internally. Only city councils of the cities with a population that exceed 800,000 people are authorized to borrow externally (Article16).
- The maximum amount of debt and guarantees shall be set fourth in the SNG budget for the budget year (Article 18).
- All SNGs may secure short-term loans for a term up to three months but within the limits of a current budget year (Article 73).
- Debt service cannot exceed 10 percent of the current general budget fund expenditures *in any budget period in which the debt is to be serviced* (Article 74).
- The failure to pay principle and interest of the debt contract on time shall prohibit the borrower from new borrowing for five years (Article 74).

Budget Code of Ukraine determines that the Cabinet of Ministers of Ukraine defines rules for local borrowing. Pursuant to this provision of the Budget Code, in 2003, the Cabinet of Ministers of Ukraine approved the procedure for borrowing to local budgets[35] that set further requirements regarding SNG borrowing, among which are:

- requirement to obtain municipal credit rating of a rating agency;
- requirement to submit documentation on borrowing for obtaining an approval of the Ministry of Finance of Ukraine summarizing that decision of the SNG on borrowing meets the requirements of the budget legislation.

Authorization requirement on central government approval is consistent with the Presidential Decree No. 655/98 of June 18, 1998, which have set such condition in respond to unsuccessful experience with Odessa municipal bond issue. The Ministry of Finance must approve each SNG borrowing without providing sovereign guarantees or assuming responsibility for SNG debt.

The Resolution of the SSMSC followed Cabinet of Ministers Decree and specified rules on Internal Municipal Bond Issues.[36] Such resolution eliminated conflicting provisions, which existed in the legislation until 2003, and introduced new rules on municipal bond issuance as compared to the legislation on corporate bonds.

Since there is a difference in some features of municipal and corporate bonds, a comparative table will allow defining pros and cons of both instruments (see Table 4).

[35] "On Approval of Procedure for Borrowing to Local Budgets", Cabinet of Ministers Decree No. 20, February 24, 2003.

[36] Resolution "On Procedure for Internal Municipal Bond Issues", SSMSC Decision No. 414, October 7, 2003.

Table 4. Comparative Features of Municipal and Corporate Bonds in Ukraine, 2003.

Characteristic	Municipal Bond	Corporate Bond
Debt amount limit	Total debt should not exceed 10% of the expenditure side of the general fund of the budget during period of debt service	No. Except for Stock Holding Companies – bond issue amount should not exceed 25% of the charter capital.
Type of borrowing	Cabinet of Ministers Decree No. 207: No direct external debt issuance. Budget Code: External borrowing is allowed for the cities, with the population of 800 000 people*	Internal and External.
Security	No	No. Optional: “additionally backed”
Intermediary	Issue organizer is required. Underwriting is not mandatory.	Underwriting is mandatory.
Central Government approval	Required	Not required
Credit rating	Required	Not required
Registration process tenure	20 working days (approval with the Ministry of Finance of Ukraine) 30 calendar days (registration with SSSMC)	30 working days (registration with SSSMC)
Duties	No state duties.	State duty: 0.1% of the nominal value of the issue.
Profit Taxes of the Holder (except Institutional investors)	General taxation rules. Institutional investors do not pay taxes on investment income.	General taxation rules

*There are six cities in Ukraine with population that is not less than 800 000 people – Kyiv, Dnipropetrovsk, Donetsk, Kharkiv, Odessa and Zaporizhzhya.

Given current differences, existing between municipal and corporate bonds, corporate bonds may be viewed as a better instrument for utilization for infrastructure financing purposes. Unless the loan is large, the process of local capital financing through municipal bond issuance seems to be overly complicated and financially burdening for municipalities. Issuance of corporate bonds allows municipalities and utilities taking advantage of the less complicated issuance process by avoiding credit rating, MinFins approval and absence of restrictions on the amount of lending.

Nevertheless, current legal provisions are still quite conflicting and pose a lot of confusion to lenders and borrowers. These relates to the issue of setting limits on the maturity of short-term loans and not setting limitation on the amount of such borrowing relative to the budget; basing a debt test as a function of expenditures rather than revenues; setting penalties that prohibit borrowing for defaulting borrowers, which hampers the ability of such borrowers to refinance the loan; difference in requirements for testing debt and guarantees; absence of the reliable methodology for determining debt limitation; absence of clear SNG bankruptcy provisions. The Government of Ukraine seeks to solve these inconsistencies and the Ministries of the Cabinet of Ministers of Ukraine currently review a Draft Law “On Local Borrowing”.

6. SNG Debt Credit Rating

Prior to approval of SNG borrowing by the Ministry of Finance of Ukraine, municipalities or Government of Autonomous Republic of Crimea should obtain rating from a credit agency on the ability of the relevant SNG to service debt. The agency may be a local or foreign legal entity, which is exclusively specializing on provision of rating services. The ability of a rating agency to perform required tasks should be proved by an expert summary of IBRD, or IMF, or EBRD[37].

Only one Ukrainian rating company has performed rating of a municipal debt issue so far, which has been accepted by the Ministry of Finance for approval of a municipal borrowing in 2003. The city of Yuzhne (Odessa oblast) obtained short-term credit rating of uaK3 (not speculative) under the National Credit Rating Scale of a Ukrainian-rating Agency "Credit – Rating." [38] This city obtained a one-year loan of UAH 2.4 million with interest of 22% p.a., which is in the higher spectrum of credit interest rate horizon (see Table 2; For details see Attachment 1, Table 4).

As of January 2004, two more cities are in the process of obtaining credit ratings, as reported by "Credit- Rating" Agency. No other precedents of municipal debt issue ratings or issuer ratings are reported, other than International rating, which has been assigned to the city of Kyiv in 2003 (see Table 5)

Table 5. Selected Ratings of Long Term Debt of International Rating Agencies in 2003

Rating Agency	**Standard & Poor's**	**Moody's Investors Service**	**Fitch Ratings**
Sovereign rating	B/Positive (1)	B1/Stable (2)	B+/Stable (3)
Municipal rating City of Kiev*	B/Stable	B2/Stable	

(1) Rating assigning date November 10, 2003
(2) Rating assigning date October 28, 2003
(3) Rating assigning date June 25, 2003
**City of Kiev has been assigned credit rating for the purpose of obtaining a fiduciary loan from Dresdener Bank for USD 150 million at 8.67% p.a. in 2003 and for the municipal internal bond issue in November 2003.*

Since there is not enough statistics on assignment of ratings to the municipalities, it is too early to make conclusions regarding the affect of credit ratings on the interest rates; however, availability of such rating is a mandatory precondition for municipal borrowing.

About ten municipalities, which have participated in PADCO/USAID "Tariff Reform and Communal Services Enterprises Restructuring Program in Ukraine" and IBRD/MDLF project during summer of 2002, view availability of a credit rating requirement as overly restraining and unjustified. Although, there is not yet clear whether it is the case, because two cities showed their ability to meet the requirement, it is obvious that there are obstacles, which are arising in practice that are caused by provision on credit rating. One that the cost of assigning the rating by the national credit agency and maintaining the rating during year may reach up to 3% of loan amount

[37] Cabinet of Ministers Decree No. 20, February 24, 2003.
[38] http://www.credit-rating.com.ua/ru/ratings/list.html

which is in the size of Yuzhne city[39]. Financial cost of rating service might become an intolerable burden for quite considerable number of cities.

II. WATER SUPPLY AND WASTEWATER SECTOR

1. Water Supply and Wastewater Sector Overview.

Total water and wastewater services charges without VAT for all customer groups in 2002 were in the range of UAH 1.5 billion,[40] including UAH 678 million (USD 283 million[41]) for piped water supply and UAH 821 million (USD 155 million) for wastewater services. In 2003 these services were provided by 379 water supply and wastewater utilities (Vodokanals) and about 800 non-specialized housing-municipal production enterprises.

Indicator	2002	2003
Total number of entities, which provide Water Supply and Wastewater services:	339	379
Private	28	36
State	24	25
Owned by Communities	287	318

Source: State Committee of Housing and Communal Services (SCHCS) (Indicators on the Status of Reforms in the Housing and Communal Services Economy, January 2004)

The National Water Sector Strategy Study, carried out by the Danish Government in 2001-2002, indicated that 83% of the urban population and 23% of the rural population is connected to centralized water supply. This means that the national coverage rate for Ukraine was 78% in year 2002.

More than 70% of the population in urban areas is connected to wastewater systems providing treatment as against only 9% in rural areas. About 26 million people in total, or approximately half of the national population, benefit from wastewater services.

Eight national programs are currently approved and affect the development of initiatives in the WWS sector in Ukraine:

- Water and Wastewater Development Program (Decree of CMU No.1269, November 17, 1997, as amended);
- Program of National Production of New Highly Efficient Coagulant and Flocculants Technologies (Decree of CMU No. 2232, December 9, 1999);
- National Program of Water Sector Development (Law of Ukraine No. 2988-III, January 17, 2002);
- National Program of Protection and Renewal of the Azov and the Black Sea Environment (Law of Ukraine No. 2333-III, March 22, 2001)

[39] http://www.pension.kiev.ua/Ukr/Analit/Review/ see PADCO, Inc. Analytical reports, prepared by PADCO's Ukraine Pension Reform Implementation Project sponsored by USAID.
[40] Estimated on the basis of statistical data from the State Committee of Housing and Communal Services of Ukraine.
[41] Exchange rate 1 USD = 5.33 UAH (on December 30, 2003)

- Plan of Primary Measures on Improving Water Supply of Residential Areas in Luhansk Oblast for 2002-2005 (Decree of CMU No. 280, March 13, 2003);
- On Improving Reliability and Efficiency of Kharkiv City and other Residential Areas of Kharkiv Oblast Water Supply Systems Functioning (Decree of CMU No. 1844, December 20, 2000);
- National Program on Ecological Recreation of the Dnepr River Basin and Improvement of Drinking water Quality (Supreme Council Decree No. 123/97, February 27, 1997)

Currently, the draft Law of Ukraine "On National Program "Drinking water of Ukraine" is being reviewed by the Ministers of the Cabinet of Ministers of Ukraine before submission to the Supreme Council for approval.

2. Institutional Arrangements for provision of Water Supply and Wastewater Services

Responsibility for provision of housing and municipal services, which includes water supply and wastewater, rests with the local self-governments, which in most cases are the owners of municipal infrastructure. As of 2003, communities own 84% of water supply and wastewater utilities. In accordance with the legislation on local self-governments, the latter are responsible for the provision of water and wastewater services that are provided by the utilities owned by the community. Such provision implicitly sets requirements for the local self-governments to ensure that sufficient financing is available for service supply on the territorial units where their power is exercised. This means that the local self-government body may choose to provide budget financing to the CSE for capital investment, or incur debt for this purpose.

Execution of communal property management functions by executive bodies of local self-governments means making decisions in regard to creation, reorganization or liquidation of the utility; setting procedures for property management; approval of the utility charter and making changes to it; approval and control of implementation of utility work plans, including strategic plans; setting rules for the use of profit and setting a portion of the profit, which should be transferred to the local budget. The head of the local self-government body, e.g. city mayor, concludes a labor contract with the utility director.

Oblast state administrations are responsible for provision of housing and communal services on the territories, where local self-governments' powers are not exercised, e.g. small cities of rayon subordination. In addition, oblast state administrations are authorized to set prices for the services that are provided by non-communally owned utilities, e.g. privatized, leased. Oblast state administrations may also set prices in case when several water and wastewater enterprises serve more than one municipality in a particular oblast. The latter situation is not yet well regulated and it is not clear if regulatory authority is assigned to the oblast state administration, on the territory of which the facilities are located, or to each local – government administration where service is provided, and facilities are owned by local self-government body.

Despite utility ownership form, water and wastewater services are provided by economically independent entities that are viewed as businesses, which are subject to enterprise taxes on money they make above the costs and other charges. CSEs are responsible to ensure sufficient and safe supply of water to all customer groups and provide wastewater collection, treatment and disposal.

There is a number of utilities, which are run by the leased companies that are registered as separate legal entities. In 2003, for the first time in practice of water supply and wastewater sector in Ukraine a long-term lease agreement has been concluded between the city of Odessa and a privately owned lease company for 49 years. Several concessions with small private entrepreneurs for water, heat and housing are operating in rural areas in Crimea.

Since utilities are operating as independent legal entities and responsible for operations, implicitly, water and wastewater managers are responsible for capital investment and utilization of best financing options available. Among them are the following:

- User charges/tariffs;
- Funds from the State budget;
- Funds from SNG budgets;
- Ecology Funds Grants;
- Grants from IFIs;
- Debt financing: IFIs' loans, commercial bank loans, credit lines at FIs, corporate bonds, and leases.
- Energy Service Company (ESCO) scheme financing;
- Private equity financing.

SNG funding of water supply and wastewater infrastructure may include:

- Subsidies from the Local budgets;
- Loans to communally owned CSEs from the Local budgets;
- Local Ecology Funds, e.g. City of Kiev Ecology Fund;
- Debt financing (within legal restrictions with respect to authority to borrow):
    a) IFIs' loans,
    b) Commercial bank loans or credit lines,
    c) Municipal bonds.

3. Tariff Policy in the Water Supply and Wastewater Sector

3.1 Tariff Regulation in Water and Wastewater Sector.

In Ukraine, the national government adopts general requirements related to identification of costs that can be recovered through water and wastewater tariffs. These requirements are spelled out in the procedures and instructions of the central executive bodies, such as the SCHCS, Ministry of Economy and on the Issues of European Integration, Anti-Monopoly Committee, Ministry of Finance, and passed to the local level to enforce. National government takes control of the situation if there is no enforcement at the local level only in the issues related to quality, safety, labor, taxes, allocation and use of budget funding provided to the utilities and anti-monopoly legislation.

There are two schemes of regulation water and wastewater tariffs in Ukraine at the local level. The executive body of the *local self-government* should regulate tariffs for water and wastewater services, which are provided *by the communally owned utility*. If the entity is *state owned*, the authority to regulate tariffs lies with the *oblast state administration*. The system of price regulation is currently reviewed because it requires improvement to allow clearer guidance on regulatory authorities of oblasts and local self-governments in cases when several water and wastewater enterprises serve more than one municipality in a particular oblast and facilities of such utilities are located in different cities; or in the cases when communally owned utility is operated by a lease company, which is by definition is not owned by a territorial community.

By definition as "non-communally owned", private enterprises are subject to price regulation by oblast state administrations. However, because there few registered privately owned water and wastewater utilities in Ukraine, this issue is not being discussed broadly yet. In some instances the regulatory powers remain with municipalities and some are exercised by oblasts. Odessa administration have announced that it reserves the power to set tariffs for the services, which will be provided by the private lease company over the term of the lease agreement, while in the city of Zolotonosha (Cherkasy oblast), the oblast administration sets tariffs for a closed joint stock water company Breeze.

Key issue, which is being discussed with respect to strict division of regulatory authorities of local governments and oblast state administrations, is the issue of subsidies, which have to be paid to utilities in case regulated tariffs are set at not full cost recovery level. In most cases regulators set tariffs based on political considerations below cost recovery level in order to protect residential customers and to make tariffs affordable to majority of the population.

Since Budget Code does not authorize oblast state administrations to be responsible for provision of housing and communal services in the oblasts, it is not clear whether oblast state administrations can allocate subsidies for reimbursing utilities for losses created from inadequate tariff regulation. In complicated schemes of service provision on the territory of one oblast by utilities of various ownership and organizational forms, inefficiencies of tariff regulation become obstacles for financially viable operation of the utilities.

Absence of budget subsidies that are required for compensating the gap between actual costs and revenues that can be billed based on the tariffs set by the regulators below cost recovery level results in sector under financing, deterioration of infrastructure and poor supply of services. Utilities, which have to operate at a loss, cannot be treated creditworthy by the lenders, access capital market and improve infrastructure and service quality. Lack of stability and predictability with respect to tariff levels is one of the greatest barriers to credit market activity.

3.2. Tariff Rules on Debt Service

Current water and wastewater tariff rules are very generous, they allow utilities including all economically justifiable cost for recovery in tariffs. The utilities can include interest expenses resulting from their financing activities into tariff calculations. The Procedure on Water and Wastewaters Services[42] provides the list of financing activities, which include borrowing through bank loans, issuance of bonds and financial leasing. Based on the terms of agreements between lending and borrowing parties, the amounts of interest can be included in the cost basis for tariff setting.

[42] Order of the SCHCS No. 139 of June 27, 2001.

The Procedure also provides for determining capital requirements in tariffs. Capital costs are defined as those associated with funding of capital investment programs, including acquisitions, construction, rehabilitation, modernization and other capital improvements of plant and facilities, and other costs related to acquisitions of non material assets, which are depreciated pursuant to the Law of Ukraine “On Enterprise Profit Tax”.

Capital costs are viewed as funding that is required for implementation of capital investment programs during the budget year in excess of depreciation, the latter is also treated as allowable expense for tariff calculation purposes. The amount of capital costs in tariff is determined based on the financing method that was chosen to support capital investment program and the amount of related costs, which have to be recovered in the budget year. Annual capital requirements have to be based on a capital investment program and a long-term financial plan. Capital items that are funded through the capital investment program are capitalized for accounting purposes and depreciated over defined period of time.

Capital investment costs can be allocated to customer classes on the basis of benefit or any other basis that would be chosen by the utility and approved by the regulators. Broad definition of capital costs allows flexibility in the choice of specific capital expenditures. However, the provisions of the Procedure leave some ambiguity, which has to be clarified trough guidelines. The Procedure does not explicitly list the capital costs, which can be recovered through tariffs in excess of depreciation. For example, current methodology does not specify whether it is possible to make planned contributions to reserve of capital investment funds, which can be established for the purpose of accumulation cash over extended periods for future investment into major facilities. It is assumed that long term financial planning will help utilities to identify future cash flow problems and they will figure out mechanisms for building up necessary reserves or accumulating capital funds. Meanwhile, utilities do not have experience with financial planning even for the budget year. At maximum, pro-forma profit and loss statement is prepared at request of the regulatory body. The Procedure could also be more specific on identification of costs associated with repayment of principle on bond issues or commercial loans, or return on equity capital.

Nevertheless, current legislation on tariff calculation is not treated as an obstacle for development of cost recovery tariffs. Tariff rules on cost identification are pretty straightforward and clear. Some improvements may be considered in the area of cost allocation and the choice of effective tariff structures.

The water and wastewater tariffs are charged separately since water supply and wastewater services are two separate types of services. Water supply normally includes water pumping, treatment and distribution to customers. Wastewater service includes wastewater collection, treatment and disposal. Each utility has its own procedure on charging customers for the services. One utility may show separate line items for water and wastewater service on the customer’s bill, some may show it as one amount. Water or wastewater tariffs are charged only for those users who receive the service.

In Ukraine, tariffs for water or wastewater have uniform structure. That is why revenues corresponding to capital charges in the tariff are not set aside (dedicated) for capital investment purposes. It is up to utility how to use actual collections and allocate resources among operating and investment activity. Very few utilities in the country plan for recovery of capital costs in the tariffs other than in the form of depreciation, which may constitute from 6 to 15% of the total costs depending on the overall cost structure of the services and level of depreciation of the fixed assets.

Despite the fact that the rules allow full cost recovery, regulators do not always follow the rules and do not increase tariffs with the increase of costs, so utilities are typically operating at a loss and have not enough resources to cover O&M costs, not speaking of capital costs.

Allowed price cap regulation, can also be viewed as a progressive regulatory option that is available in the sector. It is not currently utilized by the regulators due to absence of experience on its application, but it can be considered as a good possibility for creating incentive regulatory mechanisms in the nearest future.

3. Grant vs. Market-rate Credit in the Water Supply and Wastewater Sector

Sector analysis, which has been performed based on the data provided to the SCHCS by the oblast center municipalities, shows that with the transition from a centrally planned economy to a market-oriented one, the central government financing is reducing as compared to the funding of municipalities and funding received through user charges (Table 6). SCHCS statistics on the amounts of investment into municipal infrastructure by 19 (out 26) oblast center municipalities from 1996 until 2003 shows that the amount of funding from local budgets of municipalities exceeded amounts of State funding by almost 5 times, while in prior years this relationship was about 1 to 2 (For details, see Attachment 1,Table 6). Such change is indicative of the process of decentralization of power and transfer of the important functions to local self-governments, especially after the Law of Ukraine "On Local Self-Government" has been enacted in 1997.

Table 6. Financing of Infrastructure Capital Investment
in Oblast Centers of Ukraine, 1996-2003

(000 UAH)

Source of Funding	1996-1997	1998-1999	2000-2001	2002-2003	Total
State Budget Total	120 661.9*	22 506.4	62 950.1	79 107.4	285 225.8
%, for WWS	*93*	*78*	*62*	*55*	*75*
City Budget Total	26 902.4	60 003.1	220 489.8	373 724.4	681 119.7
%, for WWS	*50*	*37*	*31*	*40*	*37*
User Charges Total	60 836.3	71 911.0	113 094.3	141 592.8	387 434.4
%, for WWS	*35*	*6*	*50*	*32*	*38*
Bank Loans Total	18 594.0	48 231.0	112 966.1	274 780.1	454 571.2
%, for WWS	*0*	*0*	*36*	*52*	*40*
Total	226 994.6	202 651.5	509 500.3	869 204.7	1 808 351
%, for WWS	*65*	*32*	*40*	*44*	*44*

**The data for 1996 may be not adjusted for UAH, and presented in karbovanets*
Source: SCHCS, Questionnaire Survey of the Oblast Centers of Ukraine in December 2003 - January 2004.

Meanwhile, state financing continues to be provided to the local governments and their respective water and wastewater utilities in the form of transfers called “target financing for capital investment”. In 2004 State Budget, for the first time since 1995, the State has budgeted UAH 400 million (0.7 % of 2004 State Budget revenues) for investment into housing and communal economy to address issues requiring immediate solutions. There is no data yet available on the amount of overall budgetary financing that is planned for investment into water supply and wastewater sector. The State Budget funding will be granted to the cities in a form of subsidy. No subsidies with market-rate credit have been granted to the SNGs so far.

Another source of data, generated by the SCHCS for monitoring of the status of reforms in water and wastewater sector as a whole, represents information, which shows some discrepancies with the data supplied by the oblast center municipalities on the amounts of capital investment in water and wastewater sector during 2002 and 2003 (Table 7). Oblast centers alone indicated higher amounts of investments than in the whole Ukraine for the same period. This is explained by the fact that both data sources were generated with incomplete information from the regions. Nevertheless, both sources of information show similar tendencies in the change of structure of capital investment financing, which indicate higher reliance of the CSEs on their own source contributions, coming from user charges; slight increase of the share of funding received from the local budgets and increase of financing, attracted from other sources, which are assumed to be either grants or commercial loans.

Table 7. Financing of Infrastructure Capital Investment in Ukraine, 2000-2003

(000 UAH)

Indicator	**2002**		**2003**	
Total Amount of Capital Investment, including:	66 535	100%	140 367	100%
Utility Own-source Contributions	31 466	47%	80 886	58%
State Budget	18 226	27%	18 619	13%
Local budget	11 531	17%	25 356	18%
Other Sources	5 312	8%	15 735	11%

Source: SCHCS (Indicators on the Status of Reforms in the Housing and Communal Services Economy, January 2004).

In Table 7, utility own-source contributions represent financing that is available from the operating budget surplus, which may result not only from profits, but from increase in accounts payable and adjustment for depreciation.

No parastatal agencies, such as Environmental Funds, as in Poland or Czech Republic, offer programs to provide below-market lending. Environmental Funds of Ukraine provide financing to the cities or their respective utilities exclusively in the form of subsidies (grants).

5. Use of Credit in Water Supply and Wastewater Sector

Available market data on SNG borrowing shows that little long-term credit has been used for financing of the Water Supply and Wastewater sector (see Table 3). Primary lenders, so far, have been IFSs, which provided loan financing to the cities of Zaporizhzhya (EBRD) and the city of Lviv (IBRD). No other experiences with SNG debt financing of WWS sector are known.

The data in the Table 4 (Attachment 1) represents a summary of borrowing experience of various municipal CSEs with bank financing. Information reported by the cities shows that very few water utilities, operating in the oblast centers, obtained loan funding, among them are Zaporizhzhya, Dnipropetrovsk and Kirovohrad Vodokanals. Even assuming that the data is not fully representative of loan experiences of all water utilities in Ukraine, the fact that majority of oblast center utilities have not incurred debt financing for capital purposes is indicative of very weak debt financing activity in WWS even compared to other sectors of municipal services economy, e.g. heat supply sector.

6. Private Participation in Water Supply and Wastewater Investment

There is no data available on the level of investment into WWS sector by private companies, mainly because private sector involvement is only beginning. Apart from a forty-nine year lease contract in Odessa with a national private company “Infox”, several small concessions in Crimea, four joint stock companies operating in Donetsk, Kyiv and two cities of Chernihivska oblast, and nine limited liabilities companies (For details, see Attachment 1, Table 7), there is not much private sector participation observed[43].

Nevertheless, in 2003 private companies have started to express interest for entering municipal economy segment, and WWS sector in particular, as SCHCS officials remark. Private entities are mostly offering investment into municipal infrastructure over the time of a lease or concession agreement; however, no information on the type of financial instruments is available to public. Some investment companies have also conveyed SCHCS their willingness to invest into municipal services sector. In case of Odessa, it has been announced that Infox will invest UAH 500 million over seven years of operation, no plans regarding razing of company’s own credit is made public.

III. FUTURE DEVELOPMENT OF WWS SECTOR CREDIT MARKETS

1. Future of Credit Markets in the WWS Sector

National government’s policy toward development of the credit market in the WWS sector is aligned with the overall goals that are set for achievement in the housing and communal economy as a whole. The Government’s tasks are primarily focused on the development of economic stimuli for attracting investments in the entire communal services sector of Ukraine, which means that future financing of WWS sector will largely depend on achievement of these objectives.

[43] SCHCS reports 29 (2002) and 36 (2003) private operators of WWS utilities; however, detailed data on the organizational form of private utilities is available for 14 of them (For details, see Attachment 1, Table7).

Recognizing that tariffs alone cannot solve the huge financing needs of the water CSEs, developed credit markets are obviously going to play significant role in provision of long-term capital for the sector. There is no preference towards various types of debt instruments, both bank lending, municipal and corporate bond issuing can be considered as viable sources of financing, which will be competing with each other on cost basis.

Meanwhile, the Government of Ukraine is reviewing various options, which will allow increasing the level of investment into housing and communal economy and attraction of debt financing, which is currently used in critically low amounts. Technical assistance and actual project implementation by international consultants is playing significant role in this process.

IFSs, which are pursuing business opportunities in Ukraine, are intensively promoting approval of a new Law on Local Borrowing, which could clarify confusing provisions in current legislation, define SNGs bankruptcy provision, and smooth market operation.

The World Bank's initiative on establishment of the UMDF facility for providing loans for development of infrastructure has been analyzed for several years before approval. Budget Code adoption was a catalyst in this process. Since UMDF facility is not yet operating, it is not possible to describe its impact on SNG debt market development. The most recent description of the UMDF structure have been assuming that the facility will be operating through a system of commercial banks with assigning them responsibility for credit analysis, risk assessment and loan management.

The U.S. Agency for International Development currently implements Development Credit Authority project for supporting credit financing in the municipal WWS and Heat Supply sectors in Ukraine. [44] Originally, USAID's DCA was created in 1998 to mobilize local private capital through the establishment of real risk sharing relationships with private financial institutions in USAID countries and offers a vehicle for providing needed credit for an array of enterprises and underserved sectors[45].

Under DCA project in Ukraine, the US Government will provide a five-year partial guarantees to commercial banks that will enable a number of city communal enterprises (CCEs) to finance municipal infrastructure improvement. The project will entail issuance of 50% loan guarantee in local currency to banks that provide loans to the selected CCEs (with focus on energy efficiency). Two water and wastewater CCEs have been selected so far for participation in a DCA project and the required documentation packages are under review of the project staff. Commercial banks, which were chosen by the CCEs and agreed to provide loan financing under DCA project, treat the U.S. government partial guarantee as a vehicle for reducing the amount of collateral normally required from the borrower and consider reasonable reduction in the credit interest rate.

Additionally, in 2003, USAID has announced request for proposals for an Access to Credit project, the purpose of which is to mobilize credit in Ukraine for the use of small and medium

[44] PADCO, Inc. is implementing this project in WWS and Heat Supply Sector.
[45] Best Practices of USAID's Development Credit Authority. USAID Office of Development Credit. Washington, DC. August 2002.

businesses, prospective homeowners, farmers and municipalities. The core components of this project will be in the areas of mortgage lending, municipal bonds, and financial leasing and development of appropriate financial products to meet the needs of the Ukrainian SMEs, agriculture, and municipalities. The underlying objective of providing technical assistance for municipalities with municipal bond issuance is increasing the volume of local capital investment in support of essential municipal infrastructure and services, such as highways, water and sewage facilities, heals care and education.[46]

Future of credit market development in the water sector, as well as in the municipal services sector as whole, will be developing along with the needs of institutional investors, such as pension funds and insurance companies, which will have to match their funds with long term financing. In 2003, Ukrainian Supreme Council approved two major Pension Laws – The Law “On Mandatory State Pension Insurance”[47] and the Law “On Non-State Pension Provision”[48], which set basis for pension system reform and implementation of a three pillar pension system: solidarity system, mandatory accumulation system and non-state accumulation system. Corporate and municipal bonds with long-term maturities are expected to play an important role in the development of accumulated pension system in Ukraine. Pursuant to the Law “On State Pension Insurance”, 20% of the State Accumulation Fund’s of Ukraine assets can be invested in corporate bonds of Ukrainian issuers, and no more than 10% in municipal bonds. Under the Law “On Non State Pension Provision”, no more than 40% of assets of non-state pension funds can be invested in Ukrainian corporate bonds, and no more than 20% in municipal bonds.

Further involvement of financially strong private sector participant into water supply and wastewater services provision and management is also treated as a step towards cheaper credit resources.

Since there is an urgent need to identify all possible sources of financing, the Ukrainian Government is reviewing all alternative financing options. For many years the Danish Government has been providing support to Ukraine on development of various initiatives in the water sector through DANCEE program. Within current DANCEE program, consultants provide technical assistance to SCHCS in studying mechanisms for priority rehabilitation investments and alternative financing mechanisms in the municipal sector using the water sector as an example. These includes, but not limited to testing of various options for development of alternative financing mechanisms of water and wastewater sector investment. Analysis is conducted to assess whether within existing legislation mechanisms for privileged investment activities such as techno-parks, priority development zones, etc. can be used for carrying out investment programs in the water sector.

2. Obstacles to Use of Credit in WWS Sector

Availability of debt financing sources to municipal economy, and water and wastewater sector in particular, will depend on a number of factors. Latest observations of sub national

[46] The U.S. Agency for International Development's Mission to Ukraine, Belarus and Moldova (USAID/Kyiv). Request for Proposals (RFP) Number 121-03-009. Access to Credit in Ukraine. July 31, 2003.
[47] Law of Ukraine No. N 1058-IV of July 9, 2003 (Article 88).
[48] Law of Ukraine No. N 1057-IV of July 9, 2003 (Article 47).

government credit market development showed that the principle constraints to greater use of credit in this sector lie both on the demand and supply sides. On the demand side, municipalities, as well as CSEs, find that loan terms are still insufficiently attractive for financing capital projects. Interest rates that are still ranging between 17- 21% for three-year loans, as well as loan maturity, which is generally restricted by three years' tenure, pose difficulties to the utility managers in terms of finding projects with acceptable internal rate of return. No realistic alternative for pledging of physical assets as collateral is also viewed as an obstacle to greater use of credit.

In addition, there is a lack of managerial capacity and capital planning expertise at the municipal and utility level. Most of the mid and small size cities do not carry out short- or mid-term planning on regular basis. This result in absence of ready available project feasibility studies, and justified project return assessments. The most recent work performed on the issue of CSE borrowing has been sponsored by the U.S. Agency for International Development (USAID).[49] As observed by technical experts of US AID sponsored PADCO, Inc. "Tariff Reform and Communal Services Enterprises Restructuring Program in Ukraine", in many cases, CSEs channel scarce financial resources into low return and non priority investments, or make unreasonable technical decisions, which result in purchase of equipment with inadequate capacities that do not allow CSEs achieving expected savings, which potentially may be a source of debt repayment.

On the supply side, the banks are not yet willing to supply resources on long-term basis to the communally owned utilities or municipalities. The tenor of the loans is nowhere close to depreciable lives of the fixed assets, which need to be replaced. With regard to CSEs, banks do not consider them to be creditworthy. Historically, this is a reasonable assessment. In 2002 and 2003, about 66% of water and wastewater utilities have been operating with losses[50]. Lack of confidence in the borrowers flexibility with tariff setting and ability of CSEs to operate at full cost recovery basis is the major reason for high credit risk assessment associated with lending in the communal services sector, and consequently, low interest of lenders to get into this market. Those banks, which get into business with CSEs, apply very rigid collateral requirements that create obstacles for entering credit market for majority of the utilities and municipalities.

Among the key obstacles to building municipal creditworthiness, which is defined by the municipal finance experts and representatives of local self-governments, is uncertainty and unpredictability of current system of intergovernmental finance. A number of municipalities, active in implementation of reforms in the municipal services sector, are concerned with their ability to support reforms and lack of incentives for increasing their revenue base. Pursuant to the Budget Code, theoretically, municipal self-government bodies can be guarantors of SNG debt, with revenues of the local budgets being pledged as SNG debt collateral. In practice, forming of local budget revenues is tied with serious risk factors, among which are the following[51]:

[49] USAID/PADCO, Inc. "Tariff Reform and Communal Enterprise Restructuring" Project (2003), USAID/PADCO, Inc. "Development Credit Authority" Project (2003)
[50] SCHCS, Indicators on the Status of Reforms in the Housing and Communal Services Economy, January 2004.
[51] Section prepared by Inna Lunina, Institute of Economic Projections, National Academy of Sciences of Ukraine.

Low level of local budgets' revenues. Revenues of the local budgets' (not including transfers of the State Budget) in 2002-2003 constituted about 8.8 % of the GDP, including revenues of the oblast and national level subordination cities – 3.7 % of the GDP (13,2 % of consolidated budget of Ukraine revenues)[52].

Limited taxing authorities of local governments. Taxing authorities of SNGs are restricted only to setting of local taxes and fees on their respective territories (from the established list)[53] and establish local tax rates (within determined ranges)[54], as well as establish tax rates of the single tax that is imposed on small businesses and private entrepreneurs (within UAH 20 - 200 range per month)[55]. The list of local taxes and fees includes 2 taxes and 13 fees. However, their share in the local budgets' revenues constitutes less than 2%, including about 3% of revenues of the local budgets of the oblast and national level subordination cities. Single tax revenues make up about 2.5% of the local budgets' revenues, including 3.6% of revenues of the local budgets of the oblast and national level subordination cities.

Large share of State transfers in local budgets' revenues. In 2003, share of transfers exceeded 34% as compared to 18.3% in 1999 (see Table 8). In the budgets of the oblast and national level subordination cities transfers exceed 25% (see Table 9).

*Constant adjustments of the State transfers' formula***,** which means lack of stability and middle term predictability of local budgets' revenues. There have been 5 adjustments of the original transfer formula, which have been approved in September of 2001 by the Cabinet of Ministers of Ukraine (two adjustments in 2001, one - in 2002 and two – in 2003).

Methodology of transfer calculation lowers local governments' incentives to raise and improve own revenue base. State transfers (so-called state budget equalization transfer funds) are determined based on the projected amount of revenues of the respective local budget according to determined list of taxes[56]. Key on the list of taxes is income tax, licensing fees, trade patent fees, single tax of small businesses. The increase of revenue streams from these taxes means decrease of the amount of transfers from the State budget. Budget Code guarantees a certain level of local budgets' expenditures by allocating equalization transfers. In 2002, the minimum level of oblast local budgets' expenditures was reaching almost 90% of the oblast average level. In this situation, local governments do not have incentives to create environment, beneficial for business development and increase of local economic activity; however the stimuli is created for lobbying of tax privileges and tax debt write offs for the businesses, operating in their regions.

In this respect, one of the key problems of intergovernmental finance is the *problem of establishing stable base for increasing tax guarantees for local budgets.*

[52] The data on the city budgets for 2002 and 2003 is not yet available.
[53] The Law of Ukraine "On the System of Taxation" defines the list of local taxes and fees.
[54] Local tax and fees rates ranges are determined by the Decree of the Cabinet of Ministers of Ukraine "On Local Taxes and Fees".
[55] Possibilities for changing entrepreneur single tax rates are determined by the Presidential Decree " "On Simplified System of Taxation, Accounting and Reporting of Small Businesses" of July 3, 1998.
[56] The list of taxes, which are accounted for determine amount of interbudgetary transfers are specified in Articles 64 and 66 of the Budget Code of Ukraine. Projections of such tax revenues are made based on the actual data for three previous years.

Table 8. Revenue structure of SNGs Budgets: 1999-2002, %

	1999	**2000**	**2001**	**2002**	**2003** ***prior estimates***
Tax revenues	68.1	62.9	59.1	58.3	54.3
Residential income tax	19.3	34.1	35.1	38.3	39.4
Enterprise profit tax	30.0	11.3	8.5	4.4	0.4
Property taxes	1.8	2.8	2.2	2.1	1.8
Fees for specialized use of natural resources	7.3	7.8	6.5	6.4	6.0
Land tax	6.8	7.4	6.5	6.4	5.9
Internal taxes for goods and services	6.3	3.0	2.4	2.4	2.0
Local taxes and fees	2.7	2.6	2.1	1.9	1.7
Non-tax revenues	3.4	9.5	8.7	7.3	7.0
Proceeds from privatization	0.8	1.2	1.4	*	*
Own revenues of budgetary institutions		5.7	5.1	5.3	5.5
State special purpose funds	10.1	4.0	2.7	1.0	1.5
Total revenues (without transfers)	81.7	76.6	71.0	68.8	65.8
Transfers	18.3	23.4	29.0	31.2	34.2
Subsidy to Republican Budget of AR of Crimea, oblast and city of Sevastopol budgets	12.6	22.1	17.0	16.5	18.9
Cross-settlements	5.4	0.8	0.1	0.0	0.1
Subventions from the state budget	0.3	0.5	11.9	14.7	15.2
Total revenues	100.0	100.0	100.0	100.0	100.0

Source: Estimated based on the data of the Ministry of Finance of Ukraine

* revenues from privatization since 2002 are included in the section „financing“.

Table 9. Revenue Structure of the Oblast and State Subordination Level Cities, %

	1999	2001	2002
Tax revenues	73.9	57.2	62.8
Residential income tax	23.2	35.2	44.6
Enterprise profit tax	20.8	0.9	0.8
Property taxes	3.1	0.4	1.1
Fees for specialized use of natural resources	12.4	10.8	7.4
Internal taxes for goods and services	7.8	2.4	2.2
Local taxes and fees	5.3	3.9	3.2
Non-tax revenues	5.1	11.5	8.2
Proceeds from privatization	0.9	1.8	
Own revenues of budgetary institutions		6.4	6.0
State special purpose funds	0.8	1.0	0.6
Total revenues (without transfers)	79.8	70.5	74.2
Transfers	20.2	29.5	25.8
Subsidies	9.0	6.9	6.1
Cross - settlements	9.3	1.0	0.1
Subventions	1.9	21.6	19.6
Total revenues	100.0	100.0	100.0

Source: Estimated based on the data of the Ministry of Finance of Ukraine.

IV. RECOMMENDATIONS AND TECHNICAL ASSISTANCE

The principal issues, which the Ukrainian water sector has been facing for almost a decade, have now reached a point, which is critical for further development of municipal services sector as a whole. To avoid collapse of many components of the physical infrastructure systems, the national government increased focus on the water sector by creation of various National Programs in order to break a vicious circle of deteriorating service levels resulting from a complex of problems both at service provider level as well as at other stakeholders.

New Strategy for improvement efficiency of the national housing and communal services economy is presented in the Draft Law of Ukraine " The National Program of Reforming and developing Housing and Communal Economy for 2004-2010." It has summarized government's vision for the Ukrainian municipal sector development as following:

- meet the demand of all water users for affordable housing-municipal services at appropriate service levels and quality complying with state standards approaching EU standards;
- create conditions for sustainable and efficient operation and development of housing-municipal sector;
- improve transparency of relations between housing-municipal service market agents;
- decrease human-caused impact on natural objects;
- encourage economic and rational use of resources and energy resources in particular.

The tasks, which Ukrainian Government sets for implementation in housing and communal services sector of economy, show the need for utilization of best practices, which exist in international experience on creating conditions for sustainable and efficient operation and development of municipal services sector. Efficient use of financial resources attracted for investment into WWS sector has to be promoted in various ways and brought up to the national opinion leaders and water sector managers through a number of ways, among which are various training tools and technical assistance mechanisms.

Training

Develop training programs to institutionalize training process and share best practices in the area of municipal finance, utility financial and investment management, tariff regulation, private sector participation, strategic planning, citizen participation in the process of municipal infrastructure development and tariff setting etc.

This training initiatives can be delivered in various ways:

- by establishment of national or international training centers for water and wastewater managers, local government officials, regulators and other stakeholders from EECCA countries (donor grant funds may be used for this purpose; and possibilities for future operation on co-financing terms with the trainees may be considered in the future).
- through regional conferences of experts, service providers, and other stakeholders to identify ways of meeting developing capital market needs in a variety of fixed-income products with longer maturities.

Technical Assistance

At national level technical assistance may include the following:

- Analysis of opportunities for mobilizing local capital and financial markets to support water and environmental infrastructure investments in Ukraine through various sources:
    - Commercial credit;
    - UMDF funding;
    - Utilization of co-financing mechanisms, e.g. Grants with subsidized interest rates; Grants with matching funds of Local governments and CSEs; Joint funding of several local governments through Fund creation mechanisms, especially in rural areas; FIs guarantees, issued with State funding, for SNG debt; Environmental funds financing at subsidized interest rates etc.
    - Alternative financial options;
- To solve current intergovernmental finance system problems it is recommended to create a working group (of local governments' representatives, Association of Ukrainian cities, government officials of the Ministry of Finance of Ukraine, and other local and international stakeholders), which could justify (based on the system of defined economic criteria and arguments) the types of taxes, which can be used to improve revenue base of the local budgets; and possibilities for increase of tax authority of SNGs;

- Legal support with drafting legislation allowing increase of investment into municipal services infrastructure, including, but not limited to the development of effective SNG debt security provisions;
- Assisting with the design of incentive regulation system in the area of municipal services provision in monopolistic markets.

At local level. Development of the local credit markets requires significant technical assistance to potential borrowers in various areas that will strengthen local governments' capacity to invest in environmentally related infrastructure. Such areas include:

- design of municipal projects,
- financial/fiscal management,
- financial analysis and reporting,
- capital investment planning with assessment of the best possible use of the priority investment funding, taking into consideration energy conservation and water demand management,
- revenue forecasting, etc.

These technical assistance can be delivered in various ways:

- through requesting proposals from potential borrowers for technical assistance and tendering specific technical assistance to meet the potential borrowers' needs,
- by organizing a larger-scale technical assistance demonstration projects on a national-level using international and domestic experts in order to accumulate practical experience at the local level that allows to smooth implementation of newly approved legislation;
- by providing funds directly to potential borrowers so they can procure the specific technical assistance they require, etc.

Recommendation for improving the monitoring of SNG capital market developments.
Design and implementation of effective SNG debt markets will require improving the measurement and monitoring of key indicators on SNG financial markets development in Ukraine. In this context, collaboration between international donors and the Government of Ukraine may be needed allowing initiation of a program of regular statistical analysis on SNG capital market developments. The reports will be used by the various stakeholders for decision making, including members of Inter-Agency Working Group representing Government of Ukraine, International Donor Agencies, International Finance Institutions, and municipalities that was created to assist in development and implementation of financing mechanisms of local development projects, which are expected to be carried out by local self-governments without provision of sovereign guarantees.