



CENTRE
FOR ECONOMIC
STRATEGY

POLICY PAPER

HOW TO OVERCOME INEFFICIENCY OF MUNICIPAL ENTERPRISES?



The research was produced with support from Atlas Network

AUTHORS:

Bohdan Prokhorov, economist
Onufrii Lonevskyi, junior economist
Ivan Vartovnyk, intern

Reviewers:

Oleksandr Solontay, Head of Practical Policy Program of
Institute of Political Education
Taras Sluchyky, expert of Institute of Political Education

DATE:

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The Centre for Economic Strategy is an independent research agency on public policy issues. The mission of the CES is to support reforms in Ukraine in order to achieve sustainable economic growth. The Centre contributes to the development of Ukraine's economic growth strategy, performs an independent analysis of the most important aspects of national policy, and works on strengthening public support for reforms. It was established in May 2015.

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EXECUTIVE SUMMARY

There are about 14,000 municipal enterprises¹ in Ukraine (ME). The efficiency of their work as well as of state-owned enterprises (ca. 3.7 thousand) in Ukraine suffers from political interference. In this research, we focus exclusively on municipal enterprises and companies that are located in oblast centres² of Ukraine and are subordinated to the city councils (706 enterprises).

The object of this study is unitary municipal companies in oblast centres; the subject is the quality of governance of these MEs by local authorities. We do not aim to provide comprehensive recommendations that would improve the operational performance of each of the existing municipal enterprise. Instead, our goal is to determine how cities should change their approach to managing citizens' assets.

Earlier, the Centre for Economic Strategy reported that state-owned enterprises were 2.9 percentage points less profitable than private ones³, and municipal enterprises are even less profitable (median profitability of MEs tends to zero).⁴ Notably, the monopoly status has almost no effect on the profitability of MEs.⁵

Municipal enterprises tend to have a **negative return on equity and assets**. This is especially true for companies that provide services of general economic interest (water, heat and gas, house management, municipal waste management) and public transport. Most companies in these areas are in municipal ownership. They provide housing and utility services at regulated rates and have a high degree of depreciation of fixed assets. The unsatisfactory condition of many MEs is a consequence of the problems related to the functioning of the whole industry.

The average rate of return on assets (ROA) for MEs in oblast centres for the last ten years has been 0.03%; the return on equity (ROE) averages at 0.05%. At the same time, for the suppliers of water, electricity and gas and public transport, these figures are negative and range from -1% to -5% over a three-year horizon.

MEs are financed from public funds. In 2019, 68% of the MEs that we analysed in oblast centres received UAH 14.4 billion of budget funds (excluding MEs in the field of education and healthcare) - approximately 8.2% of budget expenditures of the respective cities. MEs' taxes to the city budgets do not even compensate the replenishments of the authorized capital, let alone the value of assets and taxes on land and real estate at the disposal of the MEs that the community is not receiving.

The following problems are common for all municipal enterprises:

- unclear ownership policy;
- excessive political influence;
- inefficient asset management.

The key aspect for improving the efficiency of management of municipal property is its liberation from the political influence at the local level.

¹ Ukrainian: Комунальне підприємство

² Oblast (Ukrainian: область), refers to one of Ukraine's 24 primary administrative units (regions)

³ Are state-owned enterprises less profitable than private ones? <https://ces.org.ua/chy-ye-derzhavni-pidpriyemstva-mensh-prybutkovy-za-pryvatni/>

⁴ Public Utility Companies: to sell or to keep? <https://voxukraine.org/uk/komunalni-pidpriyemstva-prodati-chi-zalishiti/>

⁵ Ibid.

The absence of real implementation of corporate governance reform at MEs is explained both by the unwillingness to reduce rent-seeking opportunities from MEs' activities and by the risk of losing operational control over the entity for which the government is politically responsible.

To solve the problems mentioned above, we recommend implementing the following steps:

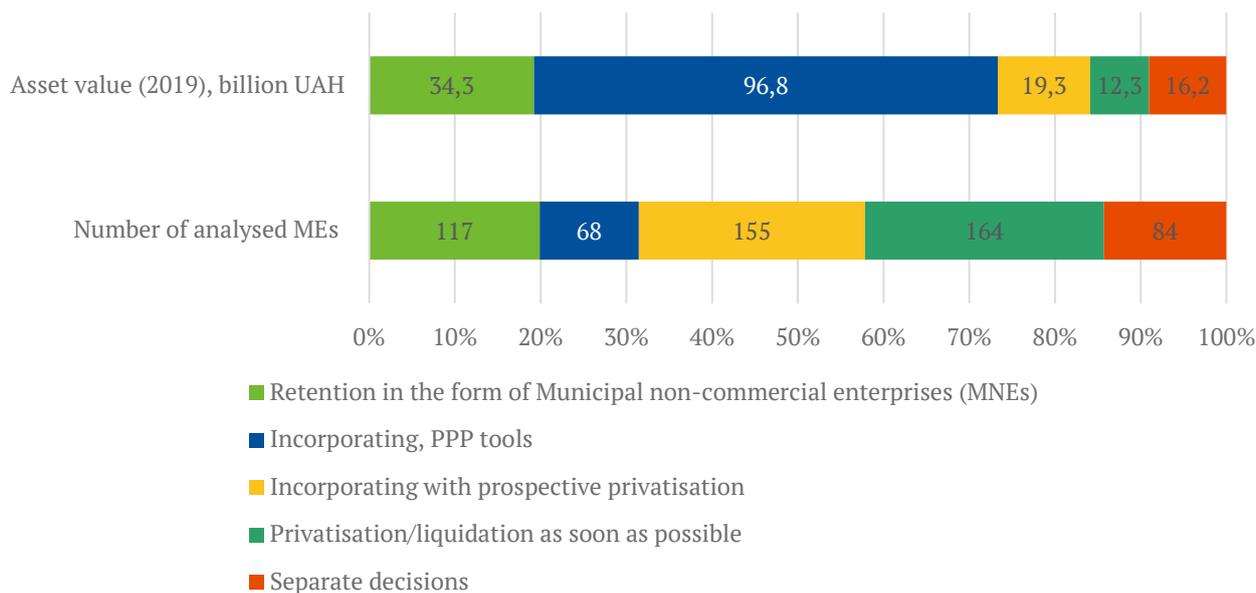
Measure	State level	Local level
Development of ownership policy	Adopt principles of an ownership policy regarding the economic entities of municipal property.	Based on the state policy, develop an ownership policy for each municipal enterprise.
Conducting the triage⁶ for existing MEs and preventing new MEs creation	Introduce the requirement for the registration of new MEs: approval of the Antimonopoly Committee regarding the influence on competition (allow municipalities to create only those companies that do not operate in competitive industries).	Develop a triage for all capable MEs – sort municipal enterprises into four groups: retention in the form of municipal non-profit (MNP), reform of corporate governance/ PPP tools, reform of corporate governance with the prospective privatisation, privatisation/liquidation.
Reform of corporate governance and privatisation	The reform of corporate governance and creation of supervisory boards should be mandatory by law for companies that remain owned by local communities - in particular, natural monopolies and MEs with a large number of assets and number of employees.	The largest MEs and natural monopolies (approximately 65% of assets in oblast centres) are to undergo corporate governance reform, which will lead to the more efficient management of large municipal enterprises and, as a result, increase the value of city assets for its residents. MEs operating in competitive sectors should be privatised.

Depending on their role for the local councils, we recommend different approaches to different MEs.

- In particular, for MEs that provide services of general economic interest (SGEI, ensure the viability of the city) the aim should be to use public-private partnership (PPP) tools to attract strategic investors, with the prospective privatisation of companies that are not natural monopolies.
- Natural monopolies and transport MEs should become appealing for investment through corporate governance reform. The main aspects of the reform should be the appointment of supervisory boards with independent members at MEs with more than 500 employees, with more than UAH 200 million asset worth or a net income of more than UAH 100 million. Such MEs should also be subject to an annual independent audit.
- Various agencies in the form of MEs that perform functions of the local councils may not be of interest for privatisation. They may be reorganised or liquidated, and the respective functions should be transferred to the executive bodies of the councils, other organisational and legal forms or these services could be purchased on the market.
- As for other municipal enterprises operating in competitive markets (markets, pharmacies, office buildings, hotels among others), privatisation or liquidation of MEs and sale of assets should be carried out.

⁶ Triage is a military and medical term of French origin that refers to the process of determining the priority of patients' treatments based on the severity of their condition. In the context of the reform of state and municipal enterprises, it refers to the sorting of entities into groups, including those to remain publicly owned, objects to be privatised and enterprises to be liquidated.

Figure 1. Triage visualisation (municipal enterprises in oblast centres, according to the main CEA (Classifier of economic activities)⁷)



Separate decisions should be made for MEs, the main CEA group of which includes several activity types, and for certain activity types

Source: CES calculations

Local authorities can improve the management of ME by implementing corporate governance reform at the largest of them - with an asset worth of about UAH 118 billion.

It is possible to attract investments and increase the level of competition in the cities by privatising about a quarter of MEs with a book value of about UAH 12 billion.

We also recommend several quick steps to reduce political influence on MEs.

On the state level:

- Remove restrictions for setting salaries for directors of MEs.
- Forbid members of city councils from working at MEs.
- Establish mandatory supervisory boards on natural monopolies and the largest MEs.
- Strengthen the power of supervisory boards legislatively.
- Enhance the AMCU's control over the creation of MEs.

On the local level:

- Create effective supervisory boards at the largest MEs.
- Privatisise and liquidate municipal enterprises that do not serve the public interest.
- Conduct an annual independent audit with a public presentation of the results.

⁷ Ukrainian: Класифікація видів економічної діяльності (КВЕД)

1. METHODOLOGY

The purpose of this study is to provide recommendations for reforming the governance of entities of the municipal sector of the economy⁸. The Commercial Code stipulates that “economic entities of the municipal sector of the economy are entities that operate based on the municipal property only, as well as entities where the share of municipal property in its authorised capital exceeds 50% or constitutes a share that provides local councils with the right of decisive influence on economic activities of these entities”.⁹ Given the diversity of municipal enterprises in Ukraine (in terms of size, market position, information availability, etc.), we focused on municipal enterprises and companies (LLC and JSC) in the regional centres of Ukraine, taking into account the following factors:

- Differences in quality and the degree of disclosure of public information about MEs in settlements of Ukraine, for which we had to collect the data by sending requests to city councils or MEs (if the administration refused to provide data on its own).
- Oblast centres are the largest cities in their regions; thus, their markets face higher competition from private business.
- In large cities, municipal enterprises are often more specialised in a particular kind of activity than in small towns.
- Oblast centres are evenly located over the territory of Ukraine.

In the process of working on this research, the Centre for Economic Strategy used a number of methods.

Desk research. We studied the papers of Ukrainian and foreign think tanks on the topic of state and municipal property. We also reviewed the literature, in particular the OECD Guidelines for Corporate Governance of State-Owned Enterprises¹⁰ and the Basic Principles for Implementing Ownership Policy for Economic Entities of the Public Sector of the Economy¹¹. In addition to that, we used other relevant information that is publicly available - charters of municipal enterprises, statistics, etc. We also reviewed the most important laws and bylaws that affect the work of municipal enterprises.

In-depth and expert interviews. As MEs governance and policymaking are carried out at the local level, we discussed the current issues and prospects of MEs reform with key stakeholders:

- directors of MEs;
- heads of governance bodies of MEs (departments of local councils);
- members of local councils;
- activists and journalists;

⁸Since the absolute majority of the analysed entities belong to the organisational and legal form of "municipal unitary enterprise", we will call all analysed entities "municipal enterprises" for simplicity. These entities are included to the following codes of organisational and legal form of management (Ukr – КОПФГ – Classifier of economic organisational and legal forms): 150, 160, 230, 231, 240, 260, 520, 540, 995. Municipal institutions, establishments and organisations (КОПФГ Classifier of economic organisational and legal forms 430) are not included in the analysis.

⁹ Part 3 of Art.24 of Commercial Code of Ukraine. <https://zakon.rada.gov.ua/laws/show/436-15#Text>

¹⁰ OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition, OECD Publishing, Paris. https://www.oecd-ilibrary.org/governance/oecd-guidelines-on-corporate-governance-of-state-owned-enterprises-2015_9789264244160-en;jsessionid=Jm_qs_IgW5zoiu7uAx4DNss0.ip-10-240-5-173

¹¹ Basic Principles for Implementing Ownership Policy for Economic Entities of the Public Sector of the Economy <https://www.kmu.gov.ua/news/minekonomrozvitku-rozrobilo-politiku-vlasnosti-u-derzhavnomu-sektori-ekonomiki>

- industry experts.

In March-May 2020, 56 interviews were conducted in five cities: Kyiv, Lviv, Odesa, Kharkiv and Vinnytsia.

Analysis of financial performance. We made requests for public information to the city councils of all oblast centres of Ukraine¹² (in some cities our requests were denied - so we sent requests to each ME separately), as well as collected available information from open sources (websites of city councils, websites of municipal enterprises). We requested information on 22 indicators over the span of ten years. We were unable to obtain the requested information in full for many companies. We analysed the indicators of 776 enterprises with available data (from which we excluded budgetary institutions and organisations)¹³. Moreover, as for 2019, the data was available only for 559 companies. For example, we collected data on Poltava's MEs from the open sources: only financial reports from 2016 to 2018 were available.

Recommendations. Based on our analysis, we have developed recommendations regarding ownership policy in the municipal sector of the economy and triage for municipal enterprises (policy breaking down MEs into groups): retention in the form of municipal non-commercial enterprise, corporate governance reform and use of public-private partnership tools, reform of corporate governance with the possibility of privatisation, fast privatisation, separate decisions on transformation.

2. THEORETICAL ASPECTS

The efficiency of state-owned enterprises (SOEs) and municipal enterprises (MEs) decreases due to both **political** (i.e. costs related to the control of companies by politicians who have political goals that do not coincide with maximum efficiency goals) and **agency costs** (i.e. costs from attempts of the management (agent) to obtain personal benefits from companies)^{14,15}. The goal of public ownership reform is to minimise both types of costs.

Earlier, the Centre for Economic Strategy found that state-owned enterprises are 2.9 percentage points less profitable than private ones¹⁶, and municipal enterprises are even less profitable (the median profitability of MEs tends to zero).¹⁷ Monopoly status has almost no effect on the profitability of MEs.¹⁸

¹² Excluding the temporarily occupied Autonomous Republic of Crimea and the city of Sevastopol; we sent inquiries to the Mariupol city council in Donetsk oblast, to the Severodonetsk city council in Luhansk oblast; we consider the city of Kyiv as the administrative center of Kyiv oblast for the purposes of this research.

¹³ This is not an exhaustive number of municipal enterprises in regional centers.

¹⁴ Qian Y. Enterprise reform in China: Agency problems and political control. *Economics of Transition*. № 4(2), pp. 422–447. <https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1468-0351.1996.tb00181.x>

¹⁵ Shleifer A., Vishny R. W. Politicians and firms. *Quarterly Journal of Economics*. № 109 (4), pp. 995–1025. <https://econpapers.repec.org/RePEc:oup:qjecon:v:109:y:1994:i:4:p:995-1025>

¹⁶ D. Yablonovskyy., O. Hamaniuk. Are the state owned enterprises less profitable than the private ones? <https://ces.org.ua/chy-ye-derzhavni-pidpryemstva-mensh-prybutkovymy-za-pryvatni/>

¹⁷ D. Mykhailyshyna. Public Utility Companies: to Sell or to Keep? <https://voxukraine.org/uk/komunalni-pidpryemstva-prodati-chi-zalishiti/>

¹⁸ Ibid.

Researchers separate formal and informal authority in economic entities.¹⁹ Real authority, i.e. effective control over decisions, is determined by the structure of information. The structure of information, in its turn, depends on the distribution of formal authority (i.e. rights to make decisions). In other words, with more formal authority, the agent will have incentives to obtain information that is more productive and, consequently, gain more real authority. However, agency costs increase as more formal authority is delegated to the agent.

Such allocation of authority leads to the absence of governance initiative on the one hand, and politically motivated or insufficiently justified business decisions, on the other. Politicians have incentives to control and subsidise state and municipal enterprises to achieve economically inefficient results for political purposes. In particular, politicians may require companies to hire more workers than needed or force them to maintain a certain level of employment at their expense²⁰. Politicians may also require MEs to achieve performance targets, which they may identify as their own achievement, even if the company meets those targets at the expense of its financial position.

The peculiarity of municipal enterprises in Ukraine is that they are controlled exclusively by local politicians without effective control by the community, directors-agents, trade unions, etc. Moreover, the assets of enterprises are not owned by them; they exercise economic²¹ and operational management²² over them. Therefore, in our opinion, the reform of municipal enterprises should be aimed primarily at minimising political influence.

Moreover, municipal and state ownership may increase the risk of non-competitive behaviour of enterprises. The Organisation for Economic Cooperation and Development (OECD) cites the following anti-competitive practices of state and municipal enterprises²³:

- **Predation** – artificially lowering prices to capture or maintain a market position.
- **Raising rivals' costs and raising barriers to entry.** This strategy is typical for vertically integrated companies that control infrastructure and provide services while using it. They are interested in preventing competitors from entering the network they control.
- **Cross-subsidisation.** It is especially typical of Ukrainian companies that do not receive compensation from state or local authorities for the provision of public services and compensate losses from profits gained from activities in other markets.
- **Strategic choice of inefficient technology.** It may be advantageous for an enterprise to use less efficient production technology because of relatively low marginal costs at the expense of higher fixed costs.

As alternative policies for reforming MEs, we consider privatisation of their assets (integral property complexes), concessions or other PPP tools, corporate governance reform and transforming them into

¹⁹ Aghion P., Tirole J. Formal and real authority. *Journal of Political Economy*. №105 (1), pp. 1–29.
<https://EconPapers.repec.org/RePEc:ucp:jpolec:v:105:y:1997:i:1:p:1-29>

²⁰ Shleifer A., Vishny R. W. Politicians and firms. *Quarterly Journal of Economics*, №109 (4), pp. 995–1025.
<https://econpapers.repec.org/RePEc:oup:qjecon:v:109:y:1994:i:4:p:995-1025>

²¹ Ukrainian: господарське відання

²² Ukrainian: операційне управління

²³ OECD. State Owned Enterprises and the Principle of Competitive Neutrality. 2009
<https://www.oecd.org/daf/competition/46734249.pdf>

another organisational and legal form. These policies have been introduced as part of state property reform in Ukraine and other transition economies and help minimise political costs for companies.

3. MAIN CHARACTERISTICS OF MUNICIPAL ENTERPRISES

A unitary municipal enterprise is a separate economic entity that has a right for commercial activity that is primarily aimed at making profit. The law gives director the right to independently approve the staffing table, open bank accounts, and make decisions within the powers defined by the charter. MEs have independent financial balance sheets; their accounts are not merged with the budget accounts of local councils. They exercise operational management (municipal non-commercial enterprise) or economic management (municipal commercial enterprise) over assets.

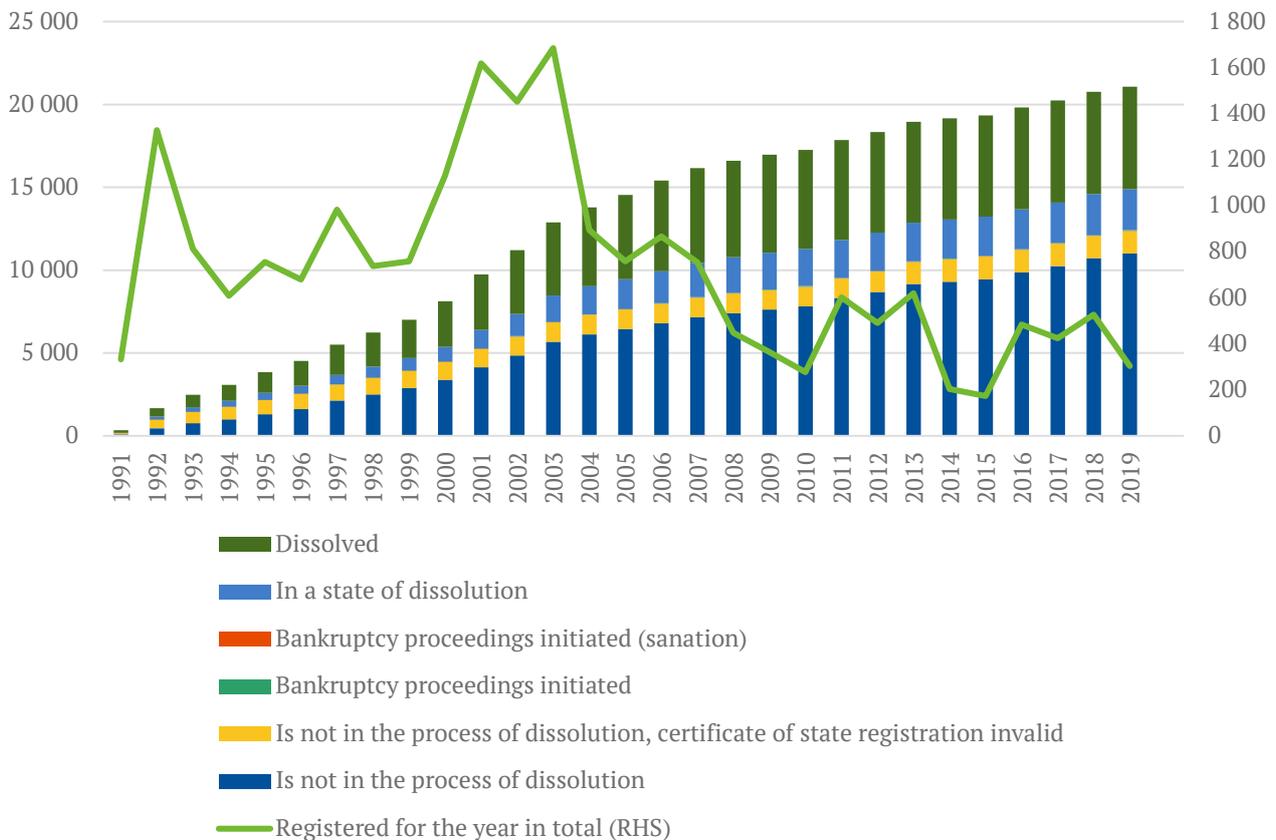
Unlike municipal enterprises, municipal institutions and organisations are non-profit. They exercise operational management over their assets, and their activities are financed from the local budget. Simply put, the purpose of their activities is to meet the needs of the local community without the purpose of making a profit. Some municipal institutions do not have independent bank accounts, but only sub-accounts.

The share of profits received by municipal commercial enterprises transferred to the local budget is determined by the session of the local council.

Municipal enterprises are registered in Ukraine every year. From 1991 to the early 2000s, the MEs that had been created during the Soviet era were re-registered. During the entire period of Ukrainian independence, more than 21 thousand enterprises were registered, of which about 11 thousand are not in the process of dissolution, and even fewer present their financial statements to the public (for example, statements of only about 7 thousand MEs were available on *YouControl* for 2018).²⁴

²⁴ B. Prokhorov, O. Lonevskyi. How does financing of municipal enterprises impair competition <https://ces.org.ua/how-does-utility-financing-impairs-competition/>

Figure 2. The number of MEs in terms of status (cumulative) and the number of MEs registrations by year



Note: status of companies as of February 29, 2020.

Some dissolved municipal enterprises were transformed into commercial ones, some into institutions.

Source: CES calculations on aggregated YouControl data

Creation of some of MEs in recent years was related to the fact that bankrupt 'old' MEs could not function anymore, but there was a need to sustain the vital functions of the city with a new economic entity.

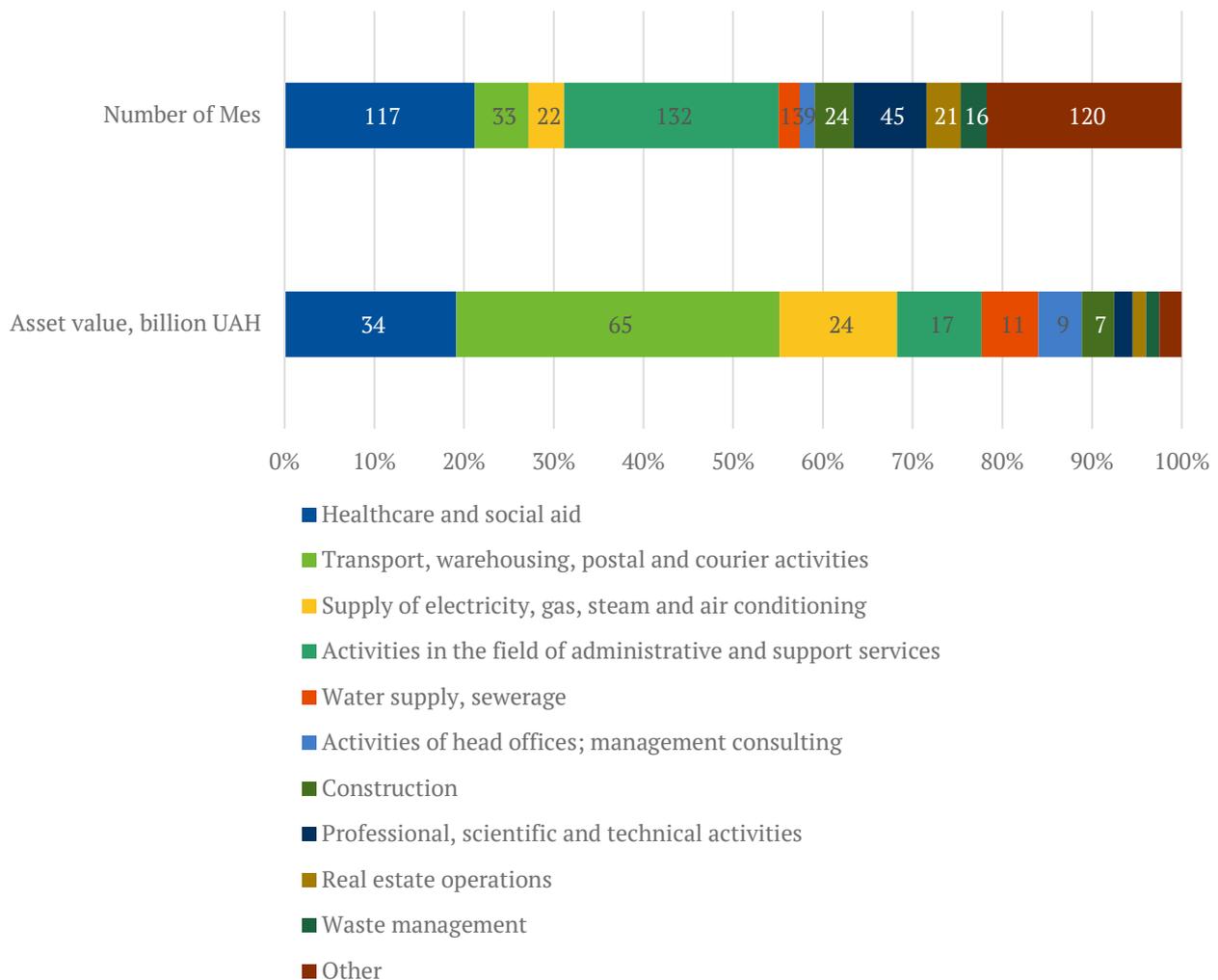
MEs operate in at least 20 industries; their number in oblast centres varies from 13 in Poltava²⁵ to 263 in Kyiv.²⁶

The largest number of assets belong to enterprises in the traditional industries for the MEs, which provide services of general economic interest, although the number of enterprises there constitutes a much smaller share. The fourth-largest industry by assets is "Activities in the field of administrative and support services". It includes mainly housing maintenance companies, whose services could be provided by private companies at the discretion of residents.

²⁵ Municipal enterprises of the city, 2020. Official site of Poltava City Council and Executive Committee. <http://www.rada-poltava.gov.ua/city/municipaleconomy/>

²⁶ The list of self-financing enterprises, institutions and organisations of the territorial community of the Kyiv city, which are subordinated to the Kyiv City Council. Extract from the Register of municipal enterprises of the territorial community of the Kyiv city as of 01.04.2020. <https://gukv.gov.ua/wp-content/uploads/2020/06/%D0%94%D0%BE%D0%B4%D0%B0%D1%82%D0%BE%D0%BA-17-1%D0%BA%D0%B2-2020.pdf>

Figure 3. The value of assets and the number of enterprises in oblast centres, 2019

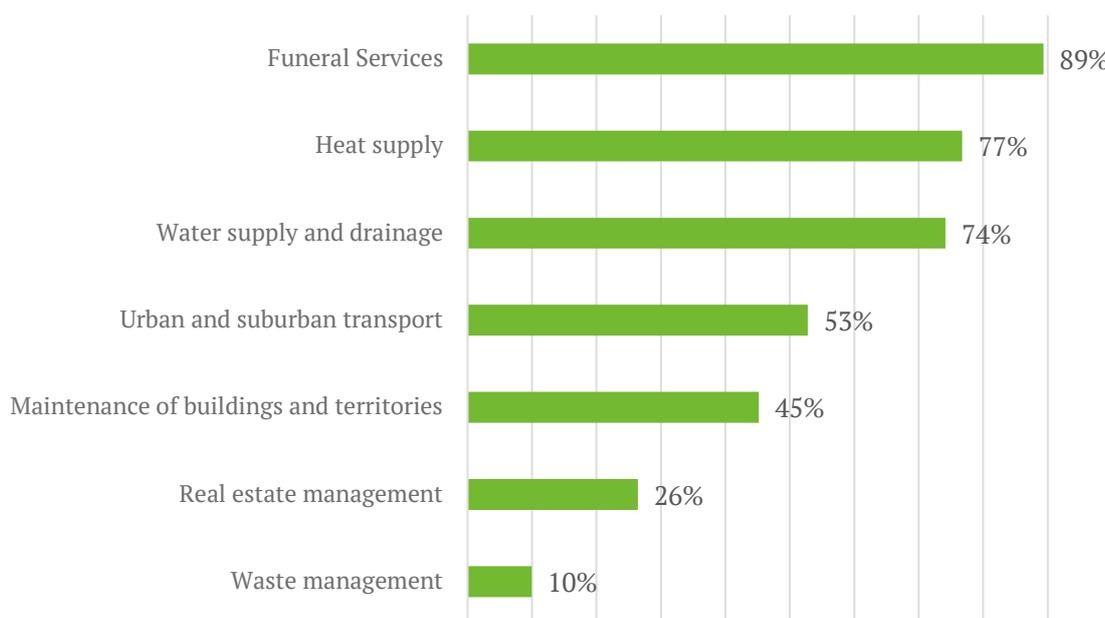


Source: Information provided by municipal enterprises in response to CES request

Although most municipal enterprises operate to provide citizens with services of general economic interest (SGEI), each city has MEs that operate in competitive markets or are in fact municipal agencies. Along with the usual enterprises in the field of housing and utility services or landscaping, there are, for example, a municipal veterinary centre and a conference bureau in Lviv.

The largest share of municipal enterprises in net sales is in funeral services (where MEs can have a dual status: as economic entities and as municipal funeral services). They are followed by heat and water supply companies (Figure 4). Transport municipal enterprises account for just over half of the market, but there is a significant amount of unreported cash that is operated by private carriers. Moreover, in real estate management, there are both enterprises that manage municipal real estate (markets, residential and non-residential premises) and MEs for the housing management (the type of activity that falls under the category of "Maintenance of buildings and territories").

Figure 4. The share of MEs in net sales in certain areas (2018)



Source: CES calculations according to YouControl data as of 2018

After analysing the available data regarding MEs located in the oblast centres (financial indicators of MEs for 2010-2019), we calculated that the average level of return on assets (ROA) for all MEs for these years was 0.03%, return on equity (ROE) averages at 0.05%.

The net loss of 154 unprofitable MEs constituted about UAH 3.13 billion, while the net profit of 314 profitable ones constituted about UAH 779.9 million in 2019.

We compared the profitability indicators of Ukrainian MEs with the indicators of all Ukrainian companies in the relevant industry (Table 1). Negative returns on equity and assets in the medium term do not cover the reproduction and maintenance of fixed assets and investment in human capital (employees), which is needed to provide public services of acceptable quality – for both municipal and private companies.²⁷

Table 1. Comparison of return on assets and equity in certain industries

Indicator	Industry	Average indicator of sample ME, 2017-2018	Average indicator in industry, 2017-2018
Return on assets	Water supply, sewerage	-5%	-2.78%
	Supply of electricity, gas, steam and air conditioning	-1%	-0.95%
	Transport and logistics	-2%	-1.15%

²⁷ I. Piontkivska, M. Repko., L. Yablonovskyy. How much does the budget lose due to the lack of good governance? <https://ces.org.ua/ua-how-much-does-the-budget-lose-due-to-the-lack-of-good-governance/>

Indicator	Industry	Average indicator of sample ME, 2017-2018	Average indicator in industry, 2017-2018
Return on equity	Water supply, sewerage	-1%	-5.83%
	Supply of electricity, gas, steam and air conditioning	-5%	-3.29%
	Transport and logistics	-3%	-2.05%

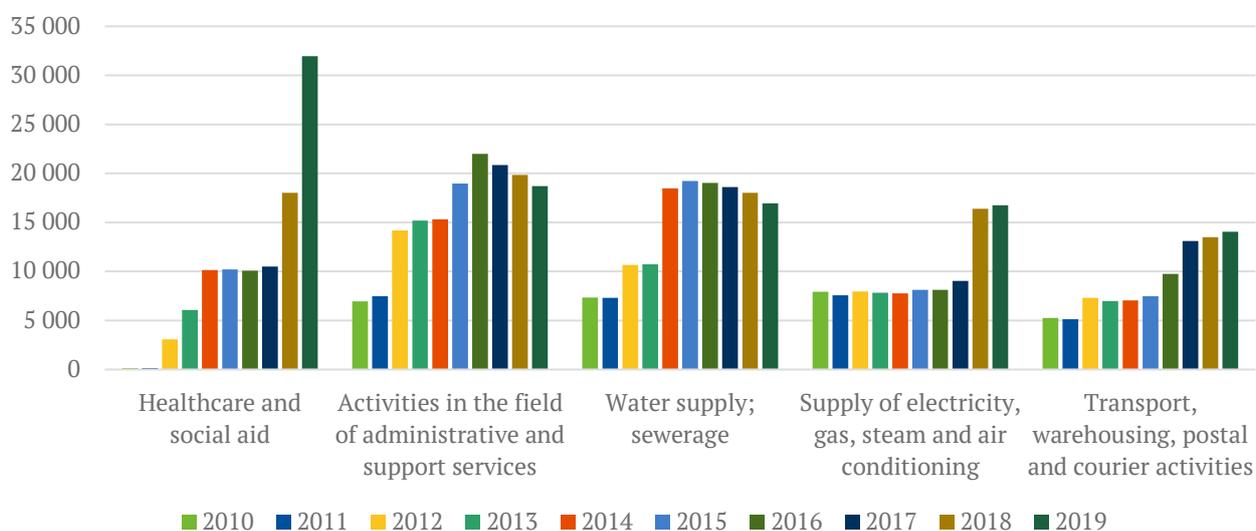
Note: for the analysed MEs, outliers are not taken into account.

Source: State Statistics Service of Ukraine, financial statements of municipal enterprises of oblast centres

In 2019, 113.2 thousand employees worked in the analysed municipal enterprises. There were 97.9 thousand in five largest areas (Figure 5), including 31.5 thousand in healthcare (hospitals transformed into municipal non-commercial enterprises).

A sharp increase in the number of employees in electricity, steam and air conditioning services in 2018 is explained by the transition of Kyiv heating complex from PJSC "Kyivenergo" to the management of ME "Kyivteploenergo", which took place on 01.05.2018.²⁸ A rapid surge in healthcare is bound to the transformation of hospitals into municipal non-commercial enterprises.

Figure 5. Number of staff in five largest areas of activity of the MEs (as of 2019)



Source: Information provided by municipal enterprises in response to a CES request

By the authorised capital (as of July 2020), such industries as water supply, passenger transport and general medical practice have been dominating. Additionally, there are private joint-stock companies with a sizeable authorised capital with a significant share in the ownership of the city community (in particular, Kyivspetstrans, Kyivenerhoholding and Kyivvodokanal).

²⁸ Official website of ME "Kyivteploenergo". More than 8,000 residents of Kyiv have applied for reimbursement of overpayments remaining in PJSC Kyivenergo to the Municipal Services Center.

<https://kte.kmda.gov.ua/ponad-8-tysyach-kyyan-podaly-zavyvy-v-tsks-na-povernennya-pereplat-v-pat-kyivenergo/>

Box 1. Examples of MEs incorporating in previous years

1.1 Kyivspetstrans

In the 2000s, Kyivspetstrans provided the removal and disposal of 100% of Kyiv's waste, took care of two landfills and caught stray animals. Today it is one of the largest economic entities in the field of municipal waste management, as well as vehicle repair.²⁹

In 2003, the Kyiv City Council decided to privatise 49% of JSC Kyivspetstrans.³⁰ Regarding large enterprises, a decision was also made to privatise shares of stocks in three hotels and JSC Kyivvodokanal. In the same year, as a result of the tender, Geotron LLC became the owner of the company's minority share. The price of a deal totalled at 16 million hryvnias.³¹ In 2013, according to media reports, people connected with the family of the former Head of the Presidential Administration (4 out of 5 council members) gained control over Kyivspetstrans. Moreover, 3 out of 5 members of the Supervisory Board represented the interests of Geotron LLC.³²

Currently, 51% of the shares remain in the ownership of the Kyiv City Council.^{33,34}

1.2 Kyivvodokanal

In 2010, there was an attempt to privatise 25.46% of shares in JSC Kyivvodokanal, which was in the municipal ownership of the territorial community of Kyiv, which was later declared invalid due to violations of the law.³⁵ In the same year, JSC "JSC Kyivvodokanal" was transformed into Public Joint-Stock Company Kyivvodokanal.³⁶

From 2010 to 2015, PJSC declared losses and did not pay dividends. In 2011, two representatives of Kyivenergoholding were appointed to the Supervisory Board, as well as a representative of the city for a term of 3 years. The principal shareholders of Kyivvodokanal are PJSC Kyivenergoholding (67%) and the Department of Municipal Property of Kyiv City State Administration (25.46%).³⁷ As of 2020, a new

²⁹ Contact Center of Kyiv city knowledge base 1551. Department of housing and utility infrastructure: PJSC "Kyivspetstrans" <https://wiki.1551.gov.ua/pages/viewpage.action?pageId=12681431>

³⁰ Decision of the Kyiv City Council of January 30, 2003 № 255/415 "On privatisation of municipal property in 2003" http://kmr.ligazakon.ua/SITE2/1_docki2.nsf/alldocWWW/DDE19089034405B9C22573C000523840

³¹ Ukrainian businessman buys part of Kyivspetstrans assets. <https://daily.ua/news/novosti/ukrainskij-biznesmen-pokupaet-chast-aktivov-kompanii-kiivspetstrans/>

³² Levochkin's surroundings became a "garbage" monopolist in Kyiv. https://ipress.ua/news/lovochkin_stav_smittievym_monopolistom_u_kyievi_24148.html

³³ M. Opanasenko. Kyiv waste will be controlled by Levochkin's family. <https://irrp.org.ua/kiyivske-smttya-kontrolyuvatime-rodina-lovochkna/>

³⁴ Andrii Hrushchynsky: "Landfill is not a means to make a profit". <http://kievlast.com.ua/text/andrij-grushhinskij-poligonne-zasib-dlya-otrimannya-pributku>

³⁵ Decision of the Economic Court of Kyiv city of October 21, 2010 in case № 6/407. <https://ips.ligazakon.net/document/SO6852?an=44>

³⁶ Official website of PJSC "Kyivvodokanal". <https://vodokanal.kiev.ua/nasha-%D1%96stor%D1%96ya>

³⁷ Kyivvodokanal has become private. <https://nv.ua/ukr/biz/markets/kijivvodokanal-stav-privatnim-1122433.html>

supervisory board was elected consisting of three members (two representatives of PJSC Kyivenergoholding and the Deputy Chairman of Kyiv City State Administration).³⁸

1.3 Kyivenergoholding

JSC "Kyivenergoholding" was established in 2006. The authorised capital was formed from 12.73% of shares of JSC Kyivenergo, 60% + 1 share of JSC Kyivgas, 67% of shares of JSC Kyivvodokanal, which at that time belonged to the Kyiv territorial community, as well as monetary funds.³⁹ In 2010, according to the Law of Ukraine on Joint Stock Companies, the organisational and legal form was changed to PJSC.

As of today, 61% of the PJSC belongs to the territorial community of Kyiv; the rest to Cypriot companies: 25% - Artio Global Investors Ltd; 14% - Denssec Limited (the ultimate beneficiaries of both are citizens of Ukraine). The company is managed by the general meeting of shareholders, the supervisory board and the general director.⁴⁰ The Supervisory Board consists of three members elected for three years.⁴¹ In 2017, two deputy mayors of Kyiv (as representatives of the Kyiv City State Administration) and a representative of Artio Global Investors Ltd. were elected to the Supervisory Board. ⁴² In 2020, the composition of the Supervisory Board was not changed.^{43,44}

It is worth noting that corporate governance in the companies mentioned above is not in line with OECD best practices, and privatisation conditions have differed significantly from those of today – in particular, the new legislation has made it possible to attract strategic investors with the help of investment advisers.

Transparency of municipal enterprises. Transparency International's ranking of Ukraine's 100 largest cities includes, among other factors, the transparency of municipal enterprises (1 to 10). In particular, the ranking evaluates publication of reports on the websites of local councils, membership of the public and city council members in supervisory boards, registration on Spending.gov.ua (a national web-portal that monitors the use of public funds), procedures for setting tariffs, etc. Among the oblast centres that we study in this report, Ternopil received the highest score (8.6 / 10) and Severodonetsk the lowest (1.7 / 10). Kyiv is in 5th place from the bottom (Figure 6).

³⁸ Voting results on the agenda of the annual general meeting of shareholders of PJSC "JSC" Kyivvodokanal", which took place on April 28, 2020. <https://vodokanal.kiev.ua/assets/>

³⁹ I. Maskalevych. "Kyivenergoholding": mix in Kyiv style. https://zn.ua/ukr/energy_market/kiyivenergoholding_miks_po-kiyivski.html

⁴⁰ Official website of PJSC "Kyivenergoholding Company". About the company http://kievenergoholding.com.ua/ru/pro_kompaniy.html

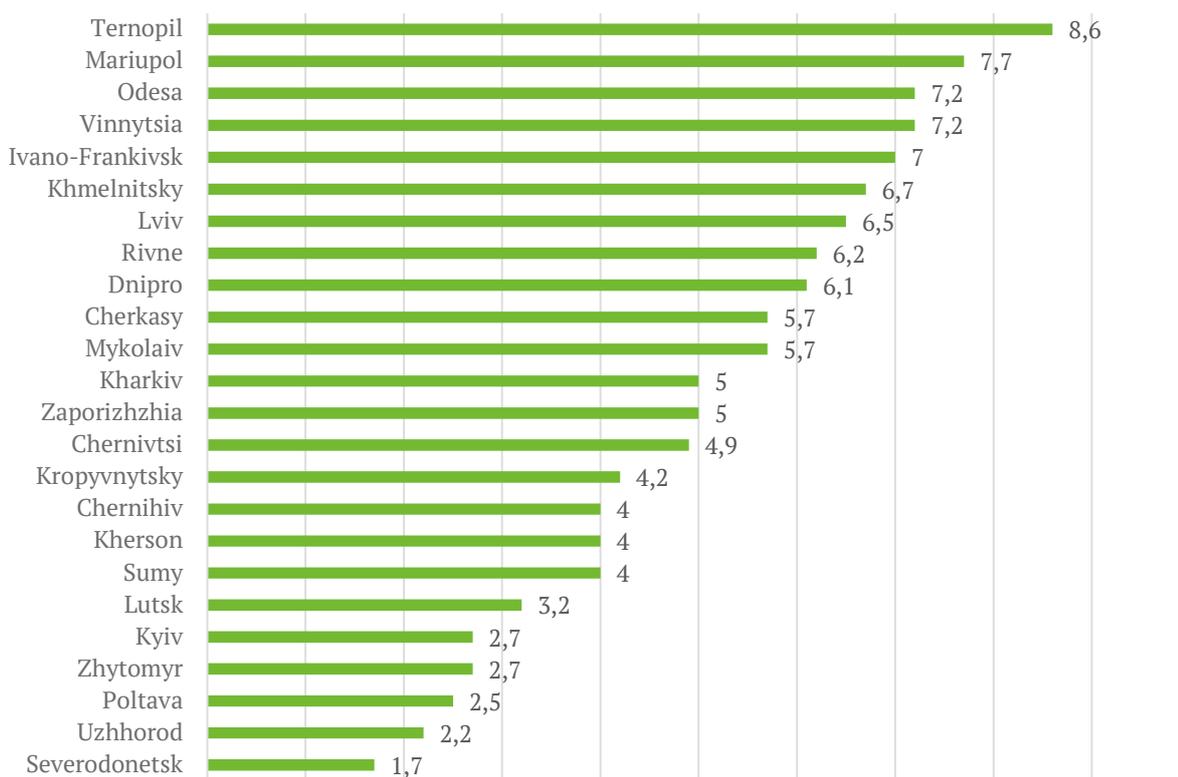
⁴¹ Provision on the Supervisory Board of PJSC Kyivenergoholding Company. <http://kievenergoholding.com.ua/files/poloj-nr-keh-vid-21.07.17.pdf>

⁴² Official website of PJSC "Kyivenergoholding Company". Special information. <http://kievenergoholding.com.ua/ru/osobliva-informatsiya2.html>

⁴³ Official website of PJSC "Kyivenergoholding Company". Notification of special information occurrence. http://kievenergoholding.com.ua/ru/osobliva-informatsiya/povidomlennya-pro-viniknennya-osoblivoyi-informatsiyi_29.04.2020.html

⁴⁴ Minutes on the registration results of shareholders (their representatives) at the annual general meeting of shareholders of PJSC "Kyivenergoholding". <http://kievenergoholding.com.ua/files/protokoli-pro-pidsumki-golosuvannya-na-zaglnih-zborah-22.04.20.pdf>

Figure 6. Assessment of MEs transparency according to the Transparent Cities methodology



Source: Transparent Cities, 2019⁴⁵

As can be seen, municipal enterprises dominate in certain industries, but even in oblast centres, there are MEs that operate in competitive markets and can distort competition. In different cities, municipal enterprises are strikingly different from each other in terms of their quantity, transparency and structure. At the same time, the return on assets and equity in those industries where MEs account for a significant share of sales is influenced by the quality of government policy and regulation.

4. CLASSIFICATION OF MUNICIPAL ENTERPRISES

The purpose of this research is to create a prototype of "triage"⁴⁶ for municipal enterprises in large cities. Therefore, for this study, we have identified the following groups of MEs:

Enterprises providing services of general economic interest (SGEI). Providing access to this kind of enterprises is a responsibility of the municipality. According to the law,⁴⁷ the list of such services was approved by the Cabinet of Ministers and supplemented with the sphere of housing and utility services in 2018, along with services for the functioning of the natural gas and electricity markets.⁴⁸ Services of general economic interest in the field of housing and utility services include:

⁴⁵ Transparency rating of cities. <https://transparentcities.in.ua/reytyngy-prozorosti-mist/porivnyaty-mista>

⁴⁶ Triage is a military and medical term of French origin that refers to the process of determining the priority of patients' treatments based on the severity of their condition. In the context of the reform of state and municipal enterprises, it refers to the sorting of entities into groups, including those to remain publicly owned, objects to be privatised and enterprises to be liquidated.

⁴⁷ On the approval of the list of the services of the general economic interest. <https://zakon.rada.gov.ua/laws/show/420-2018-%D0%BF#Text>

⁴⁸ Ibid.

- centralised heating and heat energy supply services;
- (centralised) hot and cold water supply services;
- (centralised) sewerage services;
- services of municipal waste management.

At the same time, there is no exact list of such services in the EU countries, and the Antimonopoly Committee is guided by EU practice when determining whether the state aid for companies is possible. The European Commission defines SGEI as economic activities for the provision of public services that would not be available (or would be provided on special terms regarding quality, safety, affordability, equal treatment or general accessibility) on the market without government intervention in such activities.⁴⁹

Thus, the areas of activity of the MEs, which the aforementioned resolution of the Cabinet of Ministers does not include to services of general economic interest, but which provide essential services to the residents, include the following: public transport; infrastructure related to the provision of public services; landscaping; housing management; healthcare, etc.

Enterprises that perform functions of administrative units. Such MEs include various agencies (investment, tourism, etc.) that have been established in recent years (in particular, to remove them from the budget code). Such enterprises are, in fact, separate executive subdivisions of city councils, with the difference that they are free to choose the model of remuneration, conduct economic activity, sell goods and services, and so on. However, in different cities, their economic activities differ. For example, in Lviv, there is a municipal enterprise "Conference Bureau".

Enterprises operating under competitive market conditions. For example, companies that provide services in the fields of telecommunications, security, property rental, construction and repair, trade, provision of various supportive services, etc. The services of these enterprises do not have a unique public value and can be purchased at transparent auctions from private companies. MEs in such markets are described in more detail in another study of the Centre for Economic Strategy.⁵⁰

A certain number of companies that belong to the first two groups also operate in competitive areas and thus may distort competition in related markets.

4.1. MES THAT PROVIDE SERVICES OF GENERAL ECONOMIC INTEREST

This category includes both natural monopolies identified in the respective list of the AMCU⁵¹ and MEs in markets that are not recognised as such and in which authorities and local governments should develop competition (e.g., house management). However, the interviewed profile experts note that in some markets (in particular, house management) the regulatory framework allows neither to work effectively in this market nor to regulate it.

⁴⁹Clarification on the application of state aid legislation.

<http://www.amc.gov.ua/amku/doccatalog/document?id=140886&schema=main>

⁵⁰ How does financing of municipal enterprises impair competition? <https://ces.org.ua/how-does-utility-financing-impairs-competition/>

⁵¹ Tabulated list of natural monopolies as of 25.08.20. <https://amcu.gov.ua/zvedenij-perelik-subyektiv-prirodnih-monopolij>

In the register of natural monopolies of the Antimonopoly Committee there are 3 338 enterprises of various forms of ownership, most of them – 1776 – are municipal enterprises of different levels. These are separate objects of transport infrastructure, water, heat and gas supply.⁵² The activities of these enterprises are mostly aimed not at making profit or even minimising expenses, but at ensuring the livelihood of cities and the primary household and social needs of members of local communities.

4.1.1. HOUSING AND UTILITY SERVICES

By the Government Resolution of May 23, 2018 "On approval of the list of services of general economic interest (SGEI)", the sphere of housing and utility services was included in such services.⁵³

The inclusion of these services in the list of SGEI implies that their provision by the companies of all forms of ownership can not be cost-efficient enough without receiving some state aid. At the same time, experts note that the legislative field still does not explicitly define housing and utility services. It can be considered a business that can be profitable or consumer services as in Soviet times. Therefore, the regulation of this area by different authorities may be inconsistent and play a decisive role in this area. In particular, the regulation of energy prices, on the one hand, and the regulation of tariffs for housing and utility services - on the other. Tariffs are de facto a political compromise between the enterprise, the governing body and the tariff authority.

Waste management is a separate category. According to the current Law on Housing and Municipal Services, the municipality through a competitive process chooses a company-carrier of solid waste, which can be either private or municipal. This company independently removes waste, signs contracts with landfills or incinerators. As of August 2020, a new bill "On Waste Management" was adopted in the first reading, which stipulates that cities with a population of more than 150 thousand should create a municipal operator for the waste management system in the form of a municipal enterprise. It should involve agents for removal, disposal and waste processing services, etc. on its own.⁵⁴

Water utilities are one of the largest municipal enterprises in terms of assets among the studied ones. At the request of CES, 12 water utilities owned by local communities have provided information. However, several water utilities are operated by private companies. This indicates the possibility of using public-private partnership instruments in municipal natural monopolies, including leases and concessions. Such Ukrainian examples, along with foreign ones, are important for studying and understanding the advantages and risks of public-private partnership in the municipal sphere.

Box 2. "Infovodokanal" lease

In 2003, Infox LLC leased Odessa city water supply networks (the first case of renting an integral property complex in this sphere) on the terms of payment of one hryvnia per year for a period of 49 years, but with investment liabilities of over UAH 180 million.⁵⁵ This decision was aimed at improving the condition of water supply and sewerage networks.

⁵² Ibid.

⁵³ On the approval of the list of the services of the general economic interest. <https://zakon.rada.gov.ua/laws/show/420-2018-%D0%BF#Text>

⁵⁴ Draft of the Law on Waste Management №2207-1-д from 04.06.2020. http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=69033

⁵⁵ "Infovodokanal" may lose the city water supply. <https://polyplastic.ua/ua/news/news-1068.html>

The results of the lease are ambiguous. On the one hand, a few years after the lease, the city received 24/7 water supply.⁵⁶ On the other hand, local respondents believe that the city often becomes a hostage of the commercial policy of this enterprise.

The city authorities tried to terminate the contract with Infox LLC due to non-fulfilment of the investment plan in 2006, but later signed a settlement agreement with the investor.⁵⁷ The beneficiary of Infox LLC, according to YouControl, is Mykola Zlochevsky - ex-Minister of Ecology.⁵⁸

Box 3. Bilotserkivvoda LLC

Bilotserkivvoda LLC is a water utility in Bila Tserkva, which has been a concession enterprise since 2012. Some respondents consider this enterprise to be one of the good examples of public-private partnership in the field of natural monopoly.

If we compare it with a similar-sized municipal water utility (ME "Miskvodokanal" Sumy City Council), the company shows similar or better financial performance (Table 2). In 2019, return on assets (ROA) of Bilotserkivvoda LLC was 5%, while ME "Miskvodokanal" had 8%, although until this year the indicators of ME "Miskvodokanal" were negative (2010-2013, 2015-2018): the average indicator for three years was -2%. Notice that the average return on assets for the water supply enterprises across Ukraine is approximately 2,78%.

Table 2. Comparison of individual indicators of water utilities

	Bilotserkivvoda LLC	ME "Miskvodokanal" of the Sumy city council
Period	The average from 2017 till 2019	
Net sales, thousand UAH	145,863	155,587
Gross profit / loss, thousand UAH	26,836	-10,413
Material costs, thousand UAH	57,008	85,419
Labour costs, thousand UAH	50,305	51,573
Amortisation, thousand UAH	10,097	15,702
Operational profit / loss, thousand UAH	7,869	-8,715
Net profit / loss, thousand UAH	9,759	-2,712
Total value of assets, thousand UAH	164,811	183,415

⁵⁶ History: life without water supply. <https://infoxvod.com.ua/ru/info/pro-predpriatie/istoriia>

⁵⁷ Zlochevsky, whose foreign account was arrested, trick-or-treated 44 million on a water supply system in Odessa. <http://nashigroshi.org/2014/03/31/zlochevskij-u-yakoho-areshtuvaly-zakordonnyj-rahunok-nakolyaduvav-44-miljony-na-vodokanali-u-odesi/>

⁵⁸Infox LLC. <https://youcontrol.com.ua/contractor/?id=7408203>

	Bilotserkivvoda LLC	ME "Miskvodokanal" of the Sumy city council
Received budget funds, thousand UAH	-	31,393
Number of employees, persons	677	707
ROA, %	6%	-2%
ROE, %	9%	-4%
Current liquidity ratio	1.03	0.66
Financial leverage ratio	0.49	1.06
Debt ratio	0.33	0.51
Coverage ratio	0.17	-0.10
Operating margin ratio	6%	-2%*
Gross margin ratio	19%	-5%*

* The average for 2017 and 2019 due to the absence of data for 2018.

Source: Information from company reporting, CES calculations

As noted above, the approval of service tariffs for municipal enterprises, including water utilities, may have a political aspect. It is also necessary to prevent business with politically interested beneficial owners to privately manage natural monopolies in Ukraine (lease, concession).

4.1.2. PUBLIC TRANSPORT

Municipal public transport enterprises are an example of how regulatory problems lead to a lose-lose situation for all stakeholders. In particular, in the area of urban public transport, where private carriers are in an unequal position compared to municipal enterprises.

On the one hand, transport MEs are usually not natural monopolies (except for metro) and do not cover all city routes. Fares for them are set separately from private carriers, and new vehicles are purchased for credit funds under the guarantee of local authorities.

On the other hand, the market of privately owned public transport operators does not look like an attractive target operating model due to the current low quality of rolling stock, lack of passenger accounting, limitations on reduced fares and shadowing of cash flows of private operators.

This could be explained by the fact that a municipal carrier's priority is to provide a public service, rather than to make a profit. However, in many cases, the purpose of profitability is mentioned in the first place. For example, in the charter of Lvivelectrotrans, which is a monopolist in the area of tram and trolleybus transportation in Lviv, the goal of making a profit is stated first. However, the company continually shows losses. Thus, a large part of the "income" of this enterprise is the replenishment of the authorised capital and compensation for the transportation of beneficiaries. As the experience of other countries shows, urban transportation may not be profitable and budget subsidies to carriers are a usual practice. However, the form of budget support and the efficiency of the carriers' activities (and, consequently, the efficiency of their spending) matter.

Transport municipal enterprises are not challenged by competitors and do not have adequate supervision. Therefore, the efficiency indicators that such MEs set for themselves, according to experts, are about 90-100%⁵⁹. It seems that the company sets target indicators based not on efficiency maximisation, but on its current state.

However, the main reason for the problems in the field of public transport is regulation that is not inherent in the civilised market of public transportation. In particular, unlike many European countries, Ukraine uses a competition mechanism to determine carriers on urban land transport routes (buses).⁶⁰ The organiser of the competition is the executive body of the city council or the structural subdivision authorised by it. The procedure for holding the competition has been approved by the Cabinet of Ministers of Ukraine – therefore, this procedure is mandatory for local authorities. The winner of the competition usually gets the opportunity to operate with large amounts of unaccounted cash, collecting fares on the route.

4.1.3. HEALTHCARE

In 2018-2019, during the first stage of healthcare reform, most hospitals were transformed from budget institutions into municipal non-commercial enterprises (MNPs). It was done to increase their independence and to move them from budget funding to contracts with the National Health Service, the central executive body. MEs in other areas do not have similar financial relations with the executive authorities.

A municipal non-commercial enterprise is a municipal enterprise formed at the separated property of a territorial community to perform charter functions without the purpose of making a profit. "Non-commercial" does not mean that the company can not provide paid services or receive monetary funds.

The "non-commerciality" of the enterprise means that the funds received from the provision of paid services or other sources are used exclusively to perform the charter tasks. In other words, the profit can only be reinvested, not paid to the city budget.

4.2. MUNICIPAL ENTERPRISES THAT OPERATE UNDER COMPETITIVE MARKET CONDITIONS

There were few significant changes in some industries of municipal enterprises in recent years. As a result of the reform of **municipal media** (in 2016-2019), 556 out of 664 municipal newspapers were privatised.⁶¹ Some editors of those media have created city websites, although some municipal media continue to exist (in the form of websites, TV channels, etc.).

In its report for 2019, the Antimonopoly Committee noted the dominant position of municipal enterprises on the market of **funeral services**. They can have a dual status: as economic entities and as ritual services that provide other entities with the right to carry out economic activities. There is a regulatory issue with funeral

⁵⁹ Report from the management of ME "Kyivpastrans" for 2019.

https://kpt.kyiv.ua/uploads/u/1/ZjwkbCddvj23EDmw4GRWdb7AcNQHUC8_.pdf#toolbar=0

⁶⁰ On the approval of the Procedure of the organisation of transportations of passengers and luggage by motor transport. Edition from 04.10.2016. <https://zakon.rada.gov.ua/laws/show/z1282-13#Text>

⁶¹ V. Volodovska. Media Reform: Revolution of Dignity achievements and challenges for the new government.

<https://detector.media/infospace/article/171399/2019-10-09-mediina-reforma-dosyagnennya-revoljutsii-gidnosti-ta-vikliki-dlya-novoi-vladi/>

service (municipal enterprise) giving access to the market of funeral services and simultaneously performing commercial activities on it.⁶²

MEs on other competitive markets (including pharmacies, security firms, waste disposal, etc.) are described in another study of the Centre for Economic Strategy.⁶³

5. MANAGEMENT OF MUNICIPAL ENTERPRISES

5.1. COMMUNITY AS THE OWNER

Many bodies represent the community as the owner of ME:

1. Head of the community, who appoints management and de-facto directs the work of the ME, determines the strategy and main work areas.
2. City Council, which approves company charter of an enterprise, development programme of ME, an investment programme, and also can increase the authorised capital.
3. Standing Committees on budget and competition / economic policy, municipal property and work of MEs, etc., which can be an instrument of influence, as they have the right to make recommendations and publish their conclusions on personnel and financial decisions.
4. Governing body – a subdivision of the City Council (supervises the operational activities of the enterprise).
5. Executive committee of the City Council, which can influence and control the activities and financial planning of the ME.

According to Art. 42 of the Law on Local Self-Government⁶⁴, the mayor appoints and dismisses the heads of both governing bodies and directors of municipal enterprises, institutions and organisations of the respective territorial communities^{65,66}.

One of the exclusive competencies of the local council is setting the share of profit of municipal enterprises distributed to the local budget.⁶⁷

In many cases, local council members are heads of municipal enterprises or protect their interests, they personally or members of their families are employed there, creating an acute conflict of interest and corruption risks.

5.2. ASSETS UNDER ECONOMIC MANAGEMENT

Municipal commercial enterprises execute economic management over their property.

⁶² Antimonopoly Committee of Ukraine. Annual report. 2019.

<https://amcu.gov.ua/storage/app/uploads/public/5e7/b2b/61d/5e7b2b61dcf08200345915.pdf>

⁶³ B. Prokhorov, O. Lonevskyi. How does financing of municipal enterprises impair competition <https://ces.org.ua/how-does-utility-financing-impairs-competition/>

⁶⁴ Law of Ukraine "On Local Self-Government in Ukraine". <https://zakon.rada.gov.ua/laws/show/280/97-%D0%B2%D1%80#Text>

⁶⁵ Except for the cases provided for in Part 2 of Article 21 of the Law of Ukraine "On Culture", regarding cultural institutions in the occupied territory.

⁶⁶ Law of Ukraine "On Culture" <https://zakon.rada.gov.ua/laws/show/2778-17#Text>

⁶⁷ Paragraph 30 of Article 26 of the Law of Ukraine "On Local Self-Government in Ukraine" <https://zakon.rada.gov.ua/laws/show/280/97-%D0%B2%D1%80#Text>

The economic management over strategic objects is justified by retention of assets in ownership while having the possibility of unimpeded access to them if necessary.

The property under economic management can not be sequestrated, used as collateral or security. An enterprise that has fixed assets under economic management tend to use loan guarantees instead. Local councils carry out transactions regarding the property of municipal enterprises on behalf of communities.

The property under economic management can be transferred to another user at any time. It is not clear in which case and under what circumstances such a situation may occur.

The company uses the property under economic management free of charge, so it may not be interested in its efficient use or investment in its improvement. As for non-commercial facilities and non-core assets at the disposal of MEs, the problem is that companies do not earn money on them, but bear the costs of their maintenance.

Respondents interviewed during in-depth interviews stated that MEs were not interested in optimising and improving the condition of part of the property they manage. Some respondents recommended using other legal forms with absolute legal certainty such as concessions, long-term rentals or leasing if the property cannot be transferred to full ownership. If the assets belonged to the enterprise on a lease basis, it could claim reimbursement of expenses incurred by a ME in order to upgrade or maintain its condition.

According to most respondents, the best solution is to transfer such property to the full ownership of the enterprise, specifying that certain types of transactions (by type or size of object, type of operation etc.) require the consent of the owner (general shareholders meeting or local council in case of MEs).

5.3. "SUPERVISORY BOARDS" IN MUNICIPAL ENTERPRISES

According to Article 78 of the Commercial Code of Ukraine, it is possible to establish a Supervisory Board at a municipal enterprise, which is one of the possible governing bodies. This regulation came into force on June 25, 2016, with amendments to the Commercial Code of Ukraine and legislation relating to local self-government⁶⁸.

Only 16 municipal enterprises and companies (LLC and JSC) in five cities informed us that they had supervisory boards in response to a request. Some of them are medical institutions in which supervisory boards were formed in 2019. Some are the companies described in boxes in Section 4. **However, these bodies are not supervisory boards in the sense of the OECD Guidelines on Corporate Governance of State-Owned Enterprises.**⁶⁹

After analysing the supervisory boards of municipal enterprises in Odesa, Chernivtsi, Zhytomyr and Severodonetsk, we can conclude that they are currently ineffective because they either do not perform governing functions (Odesa, Chernivtsi), or have a conflict of interest when the decisions of such boards can potentially benefit not the enterprise, but the city council or its management (Zhytomyr, Severodonetsk).

⁶⁸ Commercial Code of Ukraine, Article 78. <https://zakon.rada.gov.ua/laws/show/436-15>

⁶⁹ OECD Guidelines for Corporate Governance of State-Owned Enterprises, 2015 edition. Paris: OECD Publishing, 2019. <https://www.oecd.org/publications/2015-9789264312906-uk.htm>

In all the analysed cities, supervisory boards do not have the exclusive competences needed to perform supervision – in particular, the right to appoint and dismiss the management of the ME.

In Odesa, according to the decree⁷⁰, one third of the board consists of independent members, and the other two thirds are determined by the executive committee and the company's staff. Members of supervisory boards do not get paid for their activities. The criteria for selecting independent members are prescribed in such a way that there is no conflict of interest. SBs are created only at the largest enterprises (the company is a natural monopoly; the average number of employees is more than 2,000 people; the value of assets is more than 200 million UAH; net income is more than 100 million UAH; the authorised capital of the newly formed company is more than 100 million UAH).⁷¹

In Chernivtsi, the decree stipulates that supervisory boards are to be created in 8 of the 37 MEs.⁷² It also stipulated the right of local council members to be independent members of supervisory boards – creating a conflict of interest, as they are the representatives of the owner. Moreover, a procedure for delegating a representative of the mayor to the supervisory board was created. There is a remuneration for supervisory board members, which is a positive aspect.

In Zhytomyr, there are 11 supervisory boards at the MEs. The peculiarity of Zhytomyr in terms of the functioning of SBs is that all members of the supervisory boards are members of the city council.⁷³

In Severodonetsk in 2019, there was only one supervisory board created which consisted of 4 people for 11 municipal enterprises.⁷⁴

We see that members of local councils may be interested in joining supervisory boards. This creates risks of conflict of interest and additional political influence on the director of the ME. The presence of City Council members in supervisory boards will not contribute to the effective management of the ME.

As can be seen, de facto there are no full-fledged supervisory boards as governing bodies of ME at municipal enterprises of Ukraine. If they are created, it is rather for political PR or growth in the rankings of cities, rather than for the improvement of the governance of MEs. The principles of their operation do not allow us to talk about the performance of their functions as governing bodies, as defined in the OECD Guidelines.

⁷⁰ Decision of the Odessa City Council № 2307-VII of 26.07.2017 "On approval of the Procedure for the formation, organisation of activities and liquidation of supervisory boards of municipal unitary enterprises of the Odessa City Council".

<https://omr.gov.ua/ru/acts/council/98146/>

⁷¹ Decision of the Odessa City Council № 2161-VII of 14.06.2017 "On determining the criteria according to which the formation of the supervisory board at municipal unitary enterprises of the Odessa City Council and at business associations with a share capital of more than 50 percent of shares (parts) belong to the territorial community of Odessa is mandatory".

<https://omr.gov.ua/ru/acts/council/97048/>

⁷² Decision of Chernivtsi City Council № 647 dated April 10, 2017 "On supervisory boards of municipal enterprises"

http://search.ligazakon.ua/l_doc2.nsf/link1/HV170048.html

⁷³ Supervisory boards of municipal enterprises. Zhytomyr City Council. [http://zt-rada.gov.ua/?33398\[0\]=3670](http://zt-rada.gov.ua/?33398[0]=3670)

⁷⁴ Decision №3060 from 01.09.2019 "On the creation of the Supervisory Board of municipal enterprises, which are based on the municipal ownership of the territorial community of Severodonetsk, Luhansk oblast, approval of its regulations, personnel and the procedure for consideration of issues related to the appointment and dismissal of heads of enterprises, institutions and organisations, which are the objects of municipal ownership of the territorial community of Severodonetsk, Luhansk oblast" *Official website of the military-civil administration of Severodonetsk city, Luhansk oblast*. <https://sed-rada.gov.ua/arhiv-rishen-sesiy-miskoyi-radi/sessiya-miskradi-n56-rishennya-n3060-date14012019-1400>

5.4. FUNCTIONS OF THE MINISTRY OF COMMUNITIES AND TERRITORIES

State authorities influence the activities of MEs. In particular, the Ministry of Communities and Territories (Minregion)⁷⁵. The Ministry performs tasks related to:

- supporting utilities and managers of quality management system in creating services based on national or international standards;
- monitoring the status of payments for housing and utility services;
- improvement of settlements;
- formation of a unified technical, socio-economic policy in the field of drinking water, drinking water supply and drainage;
- approval of heat supply schemes of settlements with the population over 20 thousand inhabitants and regional programmes of modernisation of heat supply systems;
- municipal waste management, ensuring the development and implementation of state programmes in the field of municipal waste management, plans and measures in the field of municipal waste management;
- coordination of activities of local executive bodies in the field of municipal waste management;
- within the powers given by law, approvals of the terms of the tender for the lease or concession of facilities in the field of water supply, heat supply and sewerage, which are in municipal ownership; heat supply schemes of settlements with a population over 20 thousand inhabitants and regional programmes for modernisation of heat supply systems, regional programmes in the field of housing and utility services.

Box 4. Concessions

Concessions are the main form of public-private partnership for infrastructure facilities and utilities that have characteristics of a natural monopoly. As of December 2019, about 20 active concession agreements have been made regarding municipal property. These are integral property complexes of water supply systems, operators of solid waste removal, etc. A large number of contracts have been terminated. These facilities were transferred to concession under a law that expired in 2019 due to the adoption of an updated law that should activate the mechanism of public-private partnership.

5.5. FUNCTIONS OF THE ANTIMONOPOLY COMMITTEE

The Antimonopoly Committee monitors compliance with the rules of economic competition, in particular, monitors the decisions of local governments on the creation of new MEs in competitive markets, providing them with state aid, etc. The Antimonopoly Committee is also an appellate body for public procurement, in which MEs can act as an organiser and participant.

⁷⁵ Regulations on the Ministry of Development of Communities and Territories of Ukraine.
<https://www.minregion.gov.ua/about/about-min/polozhennya-pro-ministerstvo-rozvitku-gromad-ta-teritoriy-ukrayini/>

In particular, Art. 20 of the Law on the Antimonopoly Committee states that “Authorities, local governments [...] are obliged to conform with the Antimonopoly Committee of Ukraine, its territorial branches the regulation drafts and other decisions that may affect competition, in particular on the creation of economic entities, establishing and changing the rules of their conduct in the market, or those that may lead to the prevention, elimination, restriction or distortion of competition on those markets...”.⁷⁶

At the same time, the approval of the creation of new municipal enterprises by the AMCU does not work appropriately. According to the *Antitrust League*, in 2019, only 54 out of 369 newly created MEs received approval from the AMCU, in 2018 – 8 out of 507, in 2017 – only 1 out of 336 MEs.⁷⁷ But even without the consent of the Antimonopoly Committee, the city can register a municipal enterprise that will operate on a competitive market, as state registrars do not have to require the decision from the Antimonopoly Committee on the newly created ME during the process of registration of the latter.

6. SUPPORT OF MUNICIPAL ENTERPRISES BY LOCAL AUTHORITIES

The support for municipal enterprises can be provided in a variety of formal and informal ways. The formal ones are various channels of state support and aid.⁷⁸ MEs is the largest group of recipients of state support and state aid, in particular from local budgets (about 80% of the decisions of the Antimonopoly Committee in 2019).

Box 5. State aid to economic entities

Support for municipal enterprises by local authorities may fall under the definition of "state aid". Such aid can be provided in monetary and non-monetary forms (for example, tax or rental benefits, preferences, etc.).

According to the Law of Ukraine "On State Aid to Economic Entities", state aid is support in any form to economic entities at the expense of state or local resources, which distorts or threatens to distort economic competition, creating advantages for the production of certain types of goods or carrying out certain types of economic activity.⁷⁹

The law defines local resources as movable and immovable property, funds of local budgets, other funds, land, natural resources owned by territorial communities of villages, settlements, cities, districts in cities, objects of their joint property managed by district and regional councils, property belonging to the Autonomous Republic of Crimea managed by the Council of Ministers of the Autonomous Republic of Crimea;

This law does not apply to the support of economic activities related, in particular, to:

⁷⁶ Law of Ukraine "On the Antimonopoly Committee of Ukraine". <https://zakon.rada.gov.ua/laws/show/3659-12#Text>

⁷⁷ 94.8% of municipal enterprises have been created in violation of the law over the past three years. Antitrust League. 2019. <https://www.facebook.com/league.antitrust/posts/178826716935618>

⁷⁸ B. Prokhorov, O. Lonevskyi. How does financing of municipal enterprises impair competition <https://ces.org.ua/how-does-utility-financing-impairs-competition/>

⁷⁹ Law of Ukraine "On state aid to business entities", edition from 16.07.2020. <https://zakon.rada.gov.ua/laws/show/1555-18#Text>

- investing in infrastructure facilities with the use of public procurement procedures;
- provision of services of general economic interest in terms of compensation for justified costs for the provision of such services.

For example, investments in fixed assets of municipal companies may be included in local development programmes, even if such services are ordered through public procurement.⁸⁰

The MEs’ directors we interviewed also note the possibility of renting premises from cities at a reduced rental rate or free of charge or receiving equipment for MEs’ activities at the expense of the budget, which is essentially state aid that may result in distortions of competition.

There are some informal obligations of budgetary institutions to cooperate with local municipal enterprises in specific markets (in particular, the provision of telecommunications, repair, security services, public catering).

6.1. INCREASE OF THE AUTHORISED CAPITAL

The amount of the authorised capital is approved by the session of the local council on the recommendation of the governing body of ME (department of the local council). Respondents we surveyed believe that local council members often either do not require justification for such expenses when making such a decision or deliberately replenish the authorised capital to cover certain costs due to a conflict of interest, as local council members or their relatives or business partners may be directors of city MEs in many cities.

Figure 7. Average authorised capital per municipal enterprise, UAH million



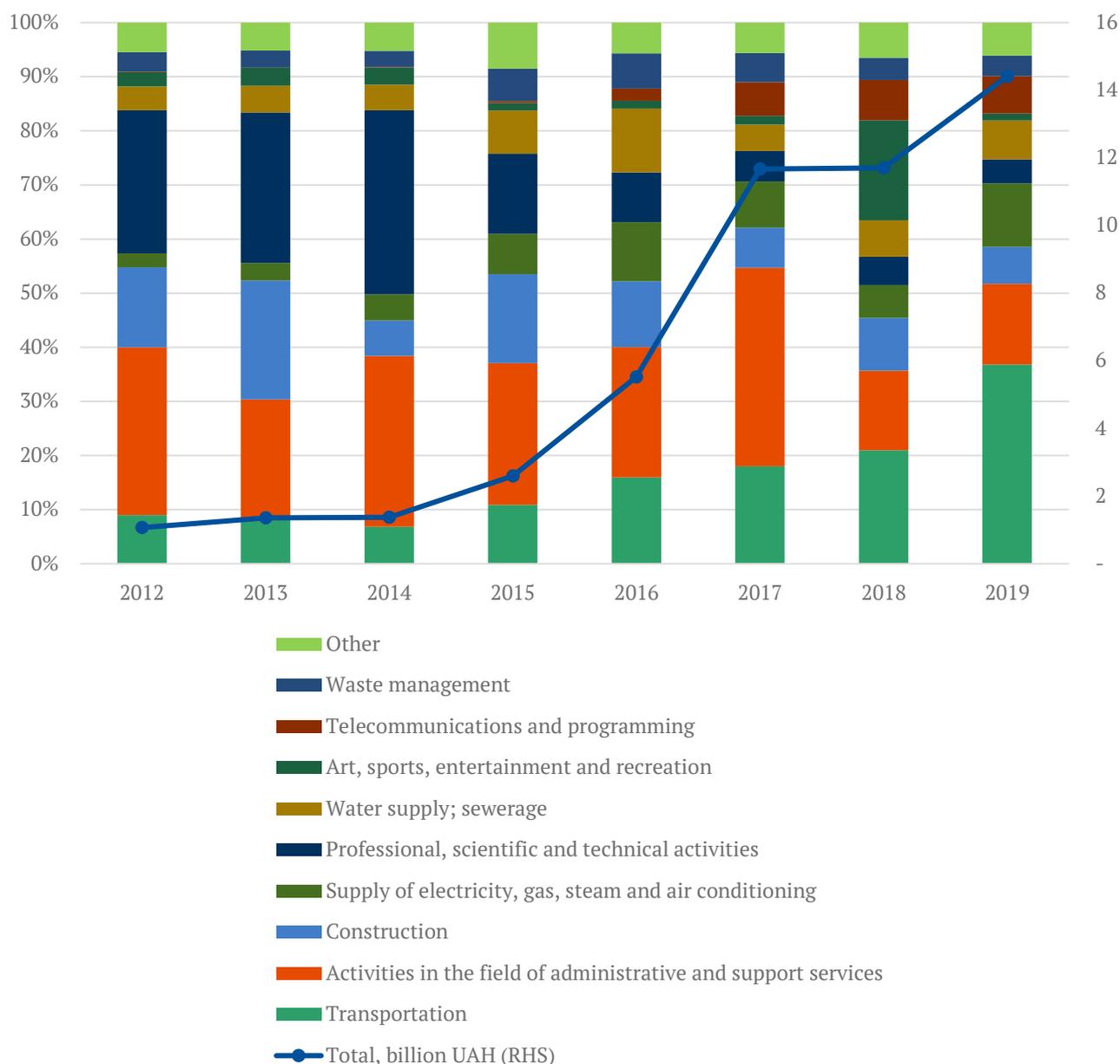
Source: Financial statements of municipal enterprises provided at the request of CES and obtained from open sources

⁸⁰ Prokhorov B. On guard of local authorities: Is there a need for need municipal militia, security and guards. <https://ces.org.ua/municipal-security/>

6.2. BUDGET FINANCING

We sent inquiries to local councils and municipal enterprises regarding the amount of funds received in any form from the local budget. The largest sums were paid to transport enterprises and enterprises in the area of administrative and support services (housing management, MEs for the maintenance of green areas and park administration were registered under this group of CEA), as well as hospitals and educational institutions⁸¹ (Figure 8). These companies can receive funds as compensation for reduced fares (transportation) and as public service providers.

Figure 8. Distribution of funds received by the MEs from local budgets by CEA



Note: educational and medical enterprises are not included.

Source: responses to public inquiries of CES by municipal enterprises subordinated to city councils of oblast centres

⁸¹ Medical and educational enterprises are not shown in the figure due to the presence of a special subsidy to cover their expenses, in contrast to other areas of activities of MEs.

In 2019, the MEs we analysed in oblast centres received ca. UAH 14.4 billion from city budgets. This is approximately 8.2% of the expenditures of the respective local budgets. Transport enterprises (investment expenditures, compensation for reduced fares, etc.) and facilities maintenance enterprises (category "Activities in the area of administrative and support services") received the most. As can be seen, the largest direct budget funds are received not by natural monopolies (except for subways), but companies operating in competitive or potentially competitive markets.

In 2019, 68% of the MEs we analysed received budget support. For 34 enterprises, such support, according to their own data, exceeded the annual net income from sales tenfold, and the total amount of budget transfers amounted to 44% of total net sales.

At the same time, some MEs allocate part of the income and tax deductions to the city budgets, but this does not compensate for the amounts of replenishment of the authorised capital, let alone the value of assets and uncollected community taxes on land and real estate. For example, for the whole of 2019, the MEs of Slovyansk community paid UAH 0.1 million in income tax. The situation is similar in Mykolaiv where MEs paid 0.1 million UAH, and also transferred 14 thousand UAH of profit. In the much larger city of Dnipro, the situation is much worse: only UAH 15,000 of income tax has been paid.

Absolute indicators of transfers from the budget include an increase in authorised capital, coverage of investment and current expenditures, direct orders from local governments etc. Therefore, these amounts of budget payments are not considered in the context of distorting competition or financing inefficiencies, but solely in the context of financing from local budgets – therefore, they require maximum transparency, accountability and effective management.

6.3. FUNCTION OF CONTRACTING AUTHORITY

Local authorities may allocate funds to MEs for the procurement of goods and services. Tenders for the purchase of fixed assets can lead to corruption risks and overload the budget process (the city budget allocates funds to the ME, which acts as a contracting authority).

A well-known example is the so-called "Case of 2.5%". In 2019, the Department of Construction and Housing of the Kyiv City State Administration transferred the functions of the contracting authority for construction, reconstruction and repair of municipal property to four specialised municipal enterprises of the City Council without a tender. However, the law on local self-government implies that such services are performed or delegated according to the result of a competition.⁸² 2.5% of the cost of construction works ordered was set as payment for the performance of the contracting authority functions. After considering the case, the AMCU ordered to return 1.4 billion UAH of the illegal state aid.⁸³

6.4. INFORMAL SUPPORT

It was mentioned in the interviews with stakeholders, as well as in the media, that other municipal-owned legal entities may be formally or informally forced to use the services of municipal enterprises. One such example is the municipal enterprise "Municipal Security" in Kyiv, which has been identified as a security

⁸² About local self-government in Ukraine. <https://zakon.rada.gov.ua/laws/show/280/97-%D0%B2%D1%80#Text>

⁸³ The AMCU has ordered four Kyiv municipal enterprises to return illegal state aid to the city. <https://nv.ua/ukr/biz/finance/chotiri-komunalnih-pidpriyemstva-kiyeva-povernut-mistu-nezakonnu-derzhodpomogu-novini-ukrajini-50044929.html>

provider for individual municipal institutions, although property protection is a competitive market.⁸⁴ Another example is the Kharkiv ME Incomedservis, which repairs computer equipment in medical institutions and organises celebrations for newborns in hospitals, whereas its economic activity is defined as "other activities in the field of healthcare".⁸⁵

7. STAKEHOLDER ANALYSIS

We analysed the attitude to the current activities, advantages and disadvantages of municipal enterprises in 5 cities of Ukraine: Kyiv, Kharkiv, Lviv, Vinnytsia and Odesa. The following stakeholder groups were interviewed using in-depth and expert interviews:

- heads of municipal enterprises;
- representatives of governing bodies of MEs (departments and managements of city councils);
- members of local councils;
- representatives of local NGOs and the media.

We interviewed respondents about their vision of reform of municipal enterprises and the ways of its implementation. The main conclusions are given below.

7.1. RATIONALE AND OBJECTIVES OF MES

MEs' directors usually do not distinguish between commercial and social goals of their enterprises, although they feel the priority of social goals.

Directors of development agencies emphasise the need to reduce the load on the city budget as one of the goals of their MEs. Making tourist information centres, development agencies, etc. a separate business unit contributes to the fact that such MEs partially or fully cover their own costs (related to the performance of local government functions) through commercial activities. They also consider their activities necessary, in contrast to MEs which operations could be performed by private companies.

"MEs are needed in the area where city control is essential: either it is an object of physical infrastructure, or it is a specific industry."

"Every municipal enterprise has to think first about how to do business in order to be independent of budgets, city or country funding."

Director of ME

7.2. ADVANTAGES AND DISADVANTAGES OF ORGANISATIONAL AND LEGAL FORM

Advantages. In terms of value for the city community, the directors of MEs consider their enterprises to be "more flexible" in terms of providing services at the order of the city. In fact, this means a willingness to operate on the principles of political rather than economic expediency.

⁸⁴ B. Prokhorov, D. Yablonovskyy. Five reasons to liquidate municipal security firms. <https://voxukraine.org/uk/p-yat-prichin-likviduvati-komunalni-ohoronni-firmi/>

⁸⁵ Objectives of the unitary enterprise ME "INCOMMEDSERVICE". <https://data.city.kharkov.ua/passport/syj3-dzJx-hBfr-JLVY.html>

All respondents mention the advantage of greater accountability to the community and local authorities through the obligation to disclose information in the form of its publication and responses to inquiries.

In addition, some respondents mention the stability of work as an advantage. MEs can get support from the city to obtain a loan at a low interest rate. It may be more difficult for a commercial enterprise to guarantee the repayment of a loan for euros.

A part of respondents who represent MEs and governance bodies consider municipal enterprises less dependent on political (formal and informal) influence and more flexible in their activities, compared to budgetary institutions and departments of city councils. Local council members and activists question MEs' lesser dependence on political influence.

Disadvantages. Directors complain about the high bureaucratic burden from the State Treasury and the supervisory bodies of city councils, as well as of the State Audit Service. They also admit that the authorities may informally influence MEs in order to impose activities that are not included in the charters. They note the inconsistency of the rights and responsibilities of the directors of MEs. For example, the director is limited in making decisions about capital investments. Another problem is the lack of motivation of the director to increase the efficiency of the ME, in contrast to private business.

Along with the advantage of being able to attract municipal credit guarantees, respondents see a problem in attracting investment in local natural monopolies: a high level of political influence and political costs (due to the specifics of managing municipal enterprises) intersects with the regulation of tariffs of NCSREPU (National Commission for State Regulation of Energy and Public Utilities).

Orders of the executive committee, city council, governing body, etc. are binding on MEs. This weakens the institutional capacity of enterprises.

7.3. APPOINTMENT OF DIRECTORS OF MUNICIPAL ENTERPRISES

According to paragraph 10 of Part 4 of Art. 42 of the Law of Ukraine "On local self-government in Ukraine", the mayor appoints and dismisses the heads of MEs. There may be a formal submission of a candidacy or endorsement (approval) of the appointment by subordinates of the mayor. However, members of the city council informally influence the appointment of the head of the ME. This is often formalised via discussion on the candidacy of the head of the ME at meetings of standing council commissions and plenary sessions of the council.

In other cases, the city council decides to create a supervisory board, which receives rights to elect the director and recommend his dismissal. However, the appointment and dismissal is still the exclusive authority of the mayor.

Competitions for the positions of directors of MEs, even if held, are often formal. Attitude towards competitions vary. Some consider them ineffective; some have a vision for their further development (for example, to add work experience criteria).

In most cities, reappointment takes place without competition.

"If the mayor is adequate and wants to finish up his term, then the critical infrastructure and directors of the MEs should not be left to someone else's choice. [...] At this time in this particular country, it is better for the mayor to make a choice by himself".

7.4. REMUNERATION OF DIRECTORS OF MUNICIPAL ENTERPRISES

The maximum amount of salaries and bonuses of heads of municipal enterprises (as well as heads of state-owned enterprises) is limited by a resolution of the Cabinet of Ministers. The size of the salary depends on the value of assets, net income from sales, number of employees, etc., and the bonus is limited or cancelled in case of arrears of wages, worsening of work quality or non-approval of the financial plan.

Thus, the city has limited powers to set the amount of remuneration of the heads of MEs. At the same time, in some cities, there are detailed conditions for rewarding directors of MEs (depending, among others, on the execution of the mayor's directives). For the most part, respondents consider the remuneration of directors of MEs to be too low and uncompetitive.

"The level of responsibility and the level of salary are not comparable. If you are constantly criminally or financially responsible for everything, then the level of salary should be comparable to this level of responsibility. [...] The salary of the director of ME "Vodokanal" and the salary of the director of PE "Oblgaz" differ ten times in favour of Oblgaz, and the responsibility is approximately equal."

However, the salaries of middle managers (in large MEs) and ordinary workers are also considered too low.

In most cases, the interviewed local council members are not aware of the salaries and incomes of heads of MEs. Some respondents believe that competitive remuneration can be provided through schemes with high salaries of deputies of the directors (when part of the compensation of the deputy is returned to the head informally).

Part of the respondents consider the salary of directors of MEs to be high and mention high competition for the position as proof. Others consider it sufficient because "in fact, the director sets his salary himself." Representatives of the expert and local opposition communities tend to believe that high competition for the positions of directors of MEs and their low official salaries are a sign of corruption in the MEs.

Directors of municipal enterprises themselves have often stated that the amount of employee income and the ME's payroll are subject of numerous public information requests, which municipal enterprises are required to respond to.

7.5. PUBLIC PROCUREMENT

Directors and heads of governing bodies consider the public procurement system to be imperfect due to the presence of unfair participants and the complexity of comprehensive procurements (such as creating a website).

Representatives of the executive branches in the cities note that cities cooperate effectively with both municipal and private companies in some areas on equal terms. This confirms the possibility of creating a competitive market instead of MEs. For example, the collaboration of the department with housing cooperatives.

"Everything on my part, everything easily becomes private, provided the contracting authority is established. [...] The advantage of private enterprises is [that] if the tender is well written, we can get [quality] services. Disadvantage - poor contracting authority may not do this. Then private individuals can "slack off". A well-drafted tender requires the cooperation of all departments of the [city council],

which is mostly not the case. Municipal enterprises are something that helps to close gaps in poor planning.”

Head of the governing body of the ME

According to experts, some municipal enterprises in competitive industries receive direct orders from the city authorities, which contradicts the legislation on state aid and protection of economic competition.

Municipal enterprises sometimes do not receive budget funds directly but participate in procurement procedures conducted by the local council. On the one hand, in this case, local authorities create an opportunity to involve private companies in the provision of services on a competitive basis. On the other hand, if a municipal enterprise wins such a tender, it de facto operates on a commercial basis.

Due to legal ambiguity, it can carry out its procurement without conducting transparent tenders using the Prozorro system only publishing a contract report with the contractor. De facto, such purchases are the use of public funds by an entity that is governed by a local government body and therefore should be carried out in the *Prozorro* procurement system.

7.6. SENTIMENTS TOWARDS REFORMING

Most directors and governing bodies of MEs consider the control of state bodies to be an obstacle to their activities. At the same time, according to some respondents, internal control and audit of the enterprise should be strengthened (which can be ensured through the presence of an audit committee on the supervisory board).

Directors of MEs complain about the imperfection (or absence) of public policy in some areas. For example, in heat supply, housing and utility services, etc. Industry experts agree with this thought.

Representatives of natural monopolies sometimes call the privatisation of oblast electricity and gas companies an example of the possibility of privatising natural monopolies in cities – with all possible risks. These risks include increased abuse of monopoly power and capture of a regulator.

In some sectors, respondents consider it acceptable to incorporate MEs with the sale of a minority stake to attract investment. However, it is crucial that investor is not a politically exposed person and does not use control over critical infrastructure for political purposes.

Many pro-government local council members note the need to reduce the control of public authorities (State Audit Service, State Regulatory Service, etc.) in favour of local control, including control from the side of supervisory boards.

Opposition members of local councils note the need to transfer control and supervision over the activities of MEs from the governing bodies (departments) and the mayor to the supervisory boards, as well as the need to strengthen (or increase efficiency) control by the Antimonopoly Committee.

However, there is no clear understanding of who should be members of the SBs and what should be their remuneration.

The position of directors of MEs regarding supervisory boards differs. Directors of smaller enterprises consider it necessary to introduce supervisory boards on large enterprises, which are natural monopolies or provide services of general economic interest.

The attitude to the introduction of supervisory boards is ambiguous both because of the novelty of this instrument and because of the lack of understanding of the importance of reducing political influence on MEs.

In general, a large number of respondents do not have a clear idea of the mandate and characteristics of supervisory boards according to the best principles of corporate governance, despite the fact that the possibility of introducing supervisory boards at MEs is provided by the Commercial Code of Ukraine. In particular, a supervisory board is confused with the civil oversight council.

Respondents usually mention only certain aspects of the supervisory board's activities. In particular, as a defence line against political factors.

"The supervisory board is [...] an increase in transparency, [...] an additional body of support, protection of the enterprise. Sometimes people who come from business and run this kind of enterprise find it hard to survive and hard to hold on because the community has a lot of distrust towards people who come and start running the enterprise. If there were supervisory boards, perhaps it would be a buffer to curb this first stream of discontent, dissatisfaction, prejudice. "

Director of ME

However, only a few respondents understand the functions of supervisory boards and the importance of establishing fair remuneration for members of SB.

8. RECOMMENDATIONS

In this section, we offer recommendations on ownership and governance policies in the sector of municipal enterprises. They do not include changes to industry policies and tariff formation in regulated industries.

The main principles of the reform should be (i) formation of coherent state policy in the field of the municipal sector of the economy, (ii) coordination of industry policies with the policy on the municipal sector, (iii) coordination of actions of central government with local authorities. We outline the concept of the reform of municipal enterprises, which takes into account (1) the principles of reform of state-owned enterprises being implemented in Ukraine according to OECD Guidelines, and (ii) peculiarities of the MEs.

8.1. PROBLEMS TO BE ADDRESSED

8.1.1. AMBIGUOUS OWNERSHIP POLICY

Given all the risks and political losses that municipal enterprises face, the state must clearly define which municipal entities can be owned by local governments and for what purpose. Therefore, the management of municipal property entities should be based on the principles of transparent and comprehensible ownership policy in the municipal sector of the economy.

8.1.2. EXCESSIVE POLITICAL INFLUENCE

A significant aspect of political influence is the dependence of directors of MEs on the political situation in the city. Municipal enterprises can meet the formal and informal requirements of the city executive branch regarding the areas of activity of MEs, investment, employment, etc.

The lack of real implementation of corporate governance reform at MEs is explained both by the unwillingness to reduce corruption opportunities related to the MEs' activities and by the risk of losing operational control over the entity for which local authorities and the mayor are politically responsible.

Along with that, there are no convenient tools for objective control of the activities of the enterprise. There is no practice of conducting an external independent audit of consolidated financial statements, and there is no effective procedure of rewarding managers of MEs for meeting key performance indicators.

8.1.3. INEFFICIENT ASSET MANAGEMENT

Equivalents of the organisational and legal form "municipal unitary enterprise", as well as "state enterprise", are not common in countries of Eastern Europe that we analysed. Instead, joint-stock companies or limited liability companies prevail.⁸⁶ These forms stipulate full ownership rights over assets and allow to attract private investment, as well as effectively manage a company that is jointly owned by several entities (including local governments).

For example, in Poland, as a result of market reforms, all municipal enterprises have been transformed into commercial ones, which has facilitated their transition to reporting and management standards similar to private companies. Local authorities can not only be founders of companies in the form of limited liability companies or joint-stock companies but also acquire a share in the ownership of such companies.⁸⁷

In Romania, local authorities are required to obtain the national regulator's permission before contracting municipal enterprise if there was no proper tender process.

8.2. KEY SOLUTIONS

8.2.1. PRINCIPLES OF OWNERSHIP POLICY AT ME

The chaotic development of municipally owned enterprises has led to different communities having different visions of the need for municipal enterprises and methods of their governance. Defining common state principles and separate ownership policies (answering the question "What for does the city own this ME?") aims, on the one hand, to remove the influence of municipal enterprises in non-relevant areas, and on the other – to limit the possibility of creating new MEs due to political expediency.

The hierarchy of decisions on ownership policies for ME should be as follows:

1. **General ownership policy:** What enterprises (by size, industry, and market position) is the state ready to have in municipal ownership in market conditions?
2. **Sectoral policy:** The state defines clear and comprehensible rules of the game on specific markets, including regulated markets and natural monopolies. Economic entities of all forms of ownership plan their activities in each industry according to the relevant state policy.
3. **Individual ownership policies:** Local governments define separate policy for each economic entity they manage.

⁸⁶ B. Prokhorov, O. Lonevskyi. How does financing of municipal enterprises impair competition <https://ces.org.ua/how-does-utility-financing-impairs-competition/>

⁸⁷ Ibid.

The Cabinet of Ministers should adopt the *Basic Principles for the Implementation of the Ownership Policy for Economic Entities of Municipal Ownership*. It should be similar to the *Basic Principles* for state-owned enterprises, already approved by the Cabinet. Such a document should be developed jointly by the Ministry of Communities and Territories, the Ministry of Economy and the Antimonopoly Committee with the involvement of municipalities. The principles of state ownership developed by the Ministry of Economy can be taken as a model.⁸⁸

Table 3. Principles of state ownership policy for enterprises and their relevance to municipal enterprises

The principle of exclusivity of state property for SOEs	Relevance for MEs	Comment
"Natural monopolies, for which no special privatisation conditions have been developed"	Natural monopolies occupy the greatest assets share among municipal enterprises: in particular, water and heat supply. At the city level, there may be areas where other players are not represented (e.g. waste removal, rail transport, etc.).	Public-private partnership mechanisms, in particular concessions, can be applied to natural monopolies.
"Ensure the security of the state."	All security functions are performed at the state level. Security services can be ordered through public procurement.	At the local level, the activities of a part of MEs are focused on meeting the vital needs of the community and in fact, do not have a commercial component. No commercial entity can afford to incur losses from water supply or transportation for years.
"Carry out other activities that are vital to society and cannot be fully performed by non-governmental economic entities."	As a result of the reform, healthcare facilities acquire the status of "municipal non-profit enterprise"; some cultural institutions (theatres, sports schools, etc.) may fall under this criterion.	Healthcare facilities are regulated by separate legislation.

Source: CES "How does the financing of municipal enterprises impair competition?"⁸⁹

Given the heterogeneity of municipal enterprises in different cities, government authorities that will be developing the principles of ownership policy should offer local governments precise tools for formulating their ownership policies for MEs (questionnaires, forms, etc.).

8.2.2. TRIAGE⁹⁰ FOR MUNICIPAL ENTERPRISES

⁸⁸ The Ministry of Economic Development has developed an ownership policy in the public sector of the economy.

<https://www.kmu.gov.ua/news/minekonomroztviku-rozrobilo-politiku-vlasnosti-u-derzhavnomu-sektori-ekonomiki>

⁸⁹ B. Prokhorov, O. Lonevskyi. How does financing of municipal enterprises impair competition <https://ces.org.ua/how-does-utility-financing-impairs-competition/>

⁹⁰ Triage is a military and medical term of French origin that refers to the process of determining the priority of patients' treatments based on the severity of their condition. In the context of the reform of state and municipal enterprises, it refers to the sorting of entities into groups, including those to remain publicly owned, objects to be privatised and enterprises to be liquidated.

Simultaneously with the development of the principles of ownership policy, the government should conduct a model triage (sorting) of municipal enterprises according to precise criteria of financial condition, type of economic activity and market position.

The collection of financial reporting data, information on managers' incomes and data on transactions of all MEs should be standardised. This data should be regularly published on the open data portal in a machine-readable format (following the example of Prozvit - the web-portal of state-owned enterprises).⁹¹

Collecting data on municipal enterprises in one place will reduce the number of requests for public information on financial indicators sent to the local councils and the MEs, and will allow anyone to benchmark and compare the performance of enterprises easily.

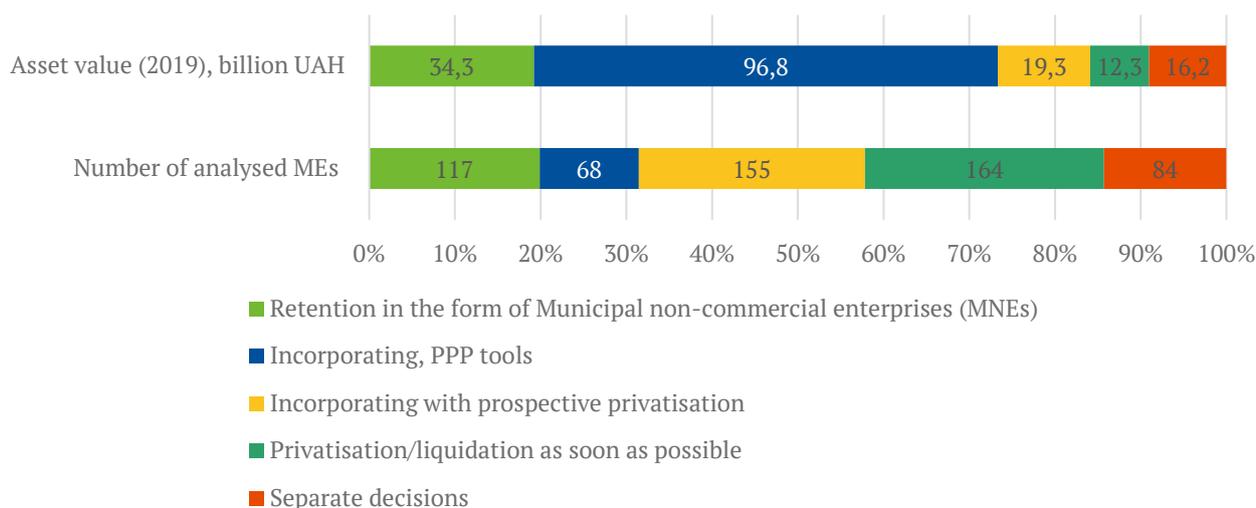
Triage (sorting of enterprises), initially carried out at the level of the national government, should give society and local governments an understanding which enterprises are needed for municipalities and communities and in what organisational and legal form. Thus, privatisation and liquidation of enterprises will reduce abuses of political power by local authorities and increase competition in markets that are now partially or fully controlled by MEs.

8.2.3. INDIVIDUAL OWNERSHIP POLICIES

The next step should be an inventory of MEs at city levels. Local governments should (involving the public or professional auditors) determine whether the activities of a particular ME are in line with the policies and strategic objectives of the city and whether they distort competition.

Based on data on municipal enterprises in oblast centres, principles of state ownership policy (Table 3), and expert interviews, we recommend the concept of triage for municipal enterprises (Figure 9). More detailed classification is given in the appendix.

Figure 9. Triage visualisation (municipal enterprises in oblast centres)



Separate decisions should be made for MEs, the main CEA group of which includes several activity types, and for certain activity types

Source: CES calculations

⁹¹ State owned enterprises. <https://prozvit.com.ua/#/>

We recommend the following groups for triage:

Retention in the form of a municipal non-commercial enterprise (MNP). Hospitals that have been transformed into municipal non-commercial enterprises in order to receive contract funding from the National Health Service (the value of assets in oblast centres is approximately UAH 34.3 billion) should remain in the legal form of a “municipal non-commercial enterprise” in the medium-term perspective.

Mandatory corporate governance reform with a potential public-private partnership. Incorporating and reform of corporate governance should be carried out at enterprises of sufficient size. Incorporating will make the attraction of private investors to the capital of enterprises easier. We recommend implementing corporate governance reform first of all at those MEs that are natural monopolies. Moreover, corporate governance reform should take place at those enterprises, where cities will not have the political will to privatise, including land transport enterprises.

Corporate governance reform with potential privatisation. Enterprises that provide services of general economic interest, but which are not natural monopolies and for which special privatisation conditions are required. In particular, one of the conditions for the privatisation of enterprises of waste management, apartment building management, etc. should be a quality sectoral regulation that will create a base on which businesses will be interested in privatisation and development and local governments will be able to implement policies in areas that they are politically responsible for.

Rapid privatisation of the rest of MEs, including those operating in competitive markets, based on the results of the MEs’ inventory at the city level. Given that MEs operate on a separate part of property owned by the community, the community must decide the fate of this property - the privatisation of the entire property complex or the liquidation of ME with retention of the property in the community ownership.

The category of "individual solutions" includes activities (CEA) that are either too broad (for example, CEA "Construction" includes enterprises for management of special housing, elevator repair companies, investment agencies, etc. – although usually, such companies belong to other CEA), or require detailed study before making recommendations (e.g. rescue service). For example, individual decisions should be made by local councils (based on the concept of ownership policy for municipal enterprises) regarding companies with a share of municipal property, depending on the needs of the local community in a particular entity.

8.2.4. CORPORATE GOVERNANCE REFORM

MEs with the largest number of assets should be incorporated. Corporate governance reform must take place there. Its purpose is to provide better financial control over the activities of the enterprise, protection of hired management from the operational intervention of local politicians and more.

One of the crucial goals of the creation of supervisory boards is the transfer of supervisory functions over the ME from the governing bodies onto the supervisory boards. Executive units of city councils, on the other hand, should focus on the development of city policies, rather than on property management functions that are not inherent for the state.

Supervisory boards are a solution for separating the functions of the city as an owner and a regulator. Thanks to supervisory boards, municipal enterprises will be able to get professional management with decent remuneration, which will be free from political pressure. Executive committees and the city council are not allowed to manage MEs.

1. The city council adopts decree on the procedure for forming supervisory boards at MEs (including rules on the odd number of members, a list of mandatory committees (including the audit committee) and exclusive authorities of the SB, including the election of its head).
2. The governing body – the department of the city council, which MEs are subordinated to, determines the policy and goals for the supervisory board.
3. NGOs, business and MEs governing body form the appointment committee. The committee elects members of the supervisory boards for every relevant MEs of the city. The majority in SB should be independent members (experts in finance, strategic management and the industry in which the enterprise operates). The minority should represent the city as the owner.
4. The Supervisory Board develops the strategy, business plan of the enterprise, the frequency and procedure for conducting the annual external audit with a public hearing of its results and establishes the principles of remuneration for the management.

We recommend to make supervisory boards mandatory for municipal enterprise if it is a natural monopoly; an average number of employees is over 500 people; asset value is over UAH 200 million; the amount of net income is over UAH 100 million.

The concept of corporate governance reform for state-owned enterprises included the criteria for asset value (UAH 2 billion or more) and net income (UAH 1.5 billion).

It is important that during the reforming, the governing bodies of all enterprises divest their non-core assets (sanatoriums and recreation facilities, dormitories, real estate that is not used for its intended purpose, etc.), as some state-owned enterprises have already done, including Ukrposhta.⁹² A large number of non-core assets are usually owned by large MEs in the areas of transport, water supply, heat supply, etc.

Box 6. Principles of formation and work of the supervisory board

The enterprise's supervisory board is a collegial body that aims to remove the company from political influence, promote the implementation of best management practices and activities of the enterprise in order to meet the goals of the owner. Creation of supervisory boards at MEs is regulated by law, namely: the Law of Ukraine "On Local Self-Government in Ukraine" (paragraph 30 of part 1 of Article 26) and the Commercial Code of Ukraine (Articles 65, 78, 78¹).

According to the Guidelines on corporate governance of the Organisation for Economic Cooperation and Development (OECD), the supervisory board is defined as the governing body of corporate governance with the functions of the strategic direction of the enterprise and monitoring of the CEO activity.

The guideline regarding the responsibilities of supervisory boards states that "the boards of SOEs should have the necessary authority, competencies and objectivity", as well as "should act with integrity and be held accountable for their actions". Thus, based on this guideline, the following basic principles of the functioning of supervisory boards (hereinafter - SB) can be distinguished in the following categories:

Principles of functioning:

⁹² Ukrposhta has started selling non-core assets. <https://www.kmu.gov.ua/news/ukrposhta-rozpochala-prodazh-neprofilnih-aktiviv>

1. Clearly defined powers, i.e. state legislation and the enterprise's charter must clearly define the functions of the SB.

2. Responsibility - SB should be accountable for the efficiency of the enterprise and act in its interests, and for the promotion of accountability, the board should follow the practices developed for the private sector.

3. Accountability to the owner (city council).

4. Fair treatment of all shareholders.

Functions that should be established as the exclusive power of the SB:

1. Setting strategy and supervising management, including approval, monitoring and analysis of corporate strategy; setting performance indicators of the enterprise and determining main risks; monitoring of information disclosure and communication processes; evaluation and monitoring of the effectiveness of the CEO.

2. Appointment and dismissal of CEO. Without this function, the SB cannot fully perform the role of oversight and take responsibility for the efficiency of the enterprise. The procedure of appointing CEO should be based on the principles of professionalism and competitive selection.

3. Setting the level of remuneration for the executives, taking into account the long-term interests of the enterprise, as well as ensuring the tying of the remuneration level to the results of the enterprise and disclosure of income information.

4. Protection of the enterprise's management from interference in its operational activities.

5. Monitoring of internal audit processes at the enterprise, as a result of which SB receives a report on the activities of internal audit and presents its financial conclusions.

6. Structured evaluation of the results and effectiveness of its own activities, which is a necessary tool for improving the professionalism of SB and its members.

The most important requirements for the composition of the supervisory board:

1. Ensuring the achievement of the enterprise's goals, which require the ability of members of SB to monitor the work of senior management and take strategic decisions.

2. Independence of judgments.

3. Sufficiency. The composition of the SB should be limited to a number which is "sufficient to ensure the effective operation" of the SB. There should also be a requirement for a minimum number of independent SB members to make decisions more objective.

4. Professionalism. It is necessary that all members of the supervisory board "are appointed based on their qualifications." It is recommended for members of the SB to have sufficient expertise in the fields of commerce, finance and knowledge of the specifics of a particular industry.

5. Responsibility. SB members must bear "defined legal responsibility", i.e. they all have the same responsibilities as members of the SB.

6. Limitation of political interference in the functioning of SBs. It is considered good practice to avoid representatives of higher political circles in the SB. In the case of municipal enterprises, deputy mayors or representatives of the executive committee can be considered as such.

Requirements for independent members: the absence of material interests, relationship with the enterprise and its management based on marital, family or other personal ties; expert competence and experience. It is desirable to attract independent members from the private sector for greater business orientation of the enterprise.

The supervisory board should consist of an odd number of members: from 5 to 11 people. The principle of remuneration for members of the supervisory board must be clearly defined. As responsibilities of the supervisory board members' should not take up the significant share of the working time, it is recommended to set a fixed amount of annual remuneration and criteria for additional remuneration.

Members of the supervisory board may be members of the supervisory boards of other municipal enterprises provided that these enterprises are not connected in economic relations and are not competitors.

Dismissals of SB members must be made either by a decision of the SB's majority or by a governing body.

Another aspect is the transfer of assets that are managed in the form of economic management to the ownership of enterprises (with restrictions on certain transactions that require the consent of the general meeting of shareholders). After the privatisation of most MEs and the incorporation of the most important ones, the need for 'municipal enterprise' as an organisational and legal form may disappear or left only for non-commercial enterprises. However, the state should learn to recognise the enterprises with a public share in statistics, establish proper corporate governance at these enterprises (if they are not privatised), collect and publish complete statistics on them.

9. CONCLUSIONS

Natural monopolies, especially important enterprises and those that ensure city vitality, as well as public service providers, can remain in municipal ownership. However, a competitive environment should be created for that. Competition should be supported and promoted in the areas and industries where it is already possible.

In addition, it is crucial to ensure adequate verification of the impact on competition of decisions of local authorities about the establishment of new economic entities (municipal enterprises and companies with a communities' share in the ownership).

It is important to have a clear and comprehensive sectoral government policy and appropriate quality regulation for the development of several sectors of municipal facilities (in particular, utilities and transport).

Most municipal enterprises should be privatised, transformed into other organisational and legal forms: incorporated (PLC and PJSC), transformed into municipal institutions, etc., and in cases of natural monopolies, the concession option should be considered. This will minimise the risks of political corruption and attract investment.

For small MEs that do not have a significant amount of assets on their balance sheets, do not carry out commercial activities or are development agencies (investment, tourism, etc.), it is worth considering the development of a separate organisational and legal form, which is closely linked to reform of local self-government.

Mandatory supervisory boards and annual independent audits will help to manage large enterprises in municipal ownership more effectively and, as a result, increase the value of the cities assets to their residents.

APPENDIX 1. CONCEPT OF TRIAGE OF MUNICIPAL ENTERPRISES IN OBLAST CENTRES

Sector	Number of MEs analysed	Asset value (2019), UAH million	
Provision of services of general economic interest	Retention in the form of MNP (municipal non-commercial enterprise)		
	86.1 Activities of medical institution	40	1,364
	86.21 General medical practice	56	32,653
	Other	21	332
	Total	117	34,349
	Incorporation, PPP tools		
	Transport and supporting activities in the field of transport, including:	16	61,881
	49.31 Urban and suburban passenger land transport	16	61,881
	Supply of electricity, gas, steam and air conditioning, including:	22	23,505
	35.13 Electricity distribution	8	547
	35.3 Supply of steam, hot water	12	22,792
	Other (35.1, 35,2)	2	166
	Water supply; sewerage	13	11,402
	Total	68	96,788
	Incorporation with prospective privatisation		
	Activities in the field of administrative and support services, including:	132	16,916
	81.1 Combined facilities support activities (buildings and territories)	83	11,751
	81.2 Cleaning activities (road management and maintenance of green areas)	24	2,749
	81.3 Provision of landscape services	9	2,228
	Other (77-82)	16	188
	Waste management	15	2,205
	Organising funerals and providing related services	8	146
	Total	155	19,267

Source: Financial statements of MEs received at the request of CES, CES calculations

(continuation)

	Sector	Number of MEs analysed	Asset value (2019), UAH million
Competitive markets	Privatisation/liquidation as soon as possible		
	Transport and supporting activities in the field of transport, including:	17	2,901
	52.21 Support maintenance of land transport	12	460
	Other (49, 52)	5	2,441
	Real estate operations	21	2,709
	Telecommunications and programming	10	2,024
	Production of information materials, TV and radio broadcasting, including:	10	395
	59.14 Cinemas	7	384
	60 Television and radio	3	11
	Provision of other types of services (95-96)	9	26
	Financial and insurance activities	1	131
	Temporary accommodation and catering, including:	16	100
	55.1 Activities of hotels and similar temporary accommodation	1	64
	56.29 Supply of other prepared meals (school meals)	15	35
	Processing industry	5	265
	Public administration and defence; mandatory social insurance, including:	4	47
	84.11 General public management (municipal protection)	1	2
	84.24 Activities in the field of protection of public order and safety (municipal guard)	3	44
	Other trade and repair work, including:	8	25
	47.73 Pharmacies	5	14
	Other (45-46)	3	11
	Professional, scientific and technical activities, including:	45	3,652
	75 Veterinary activities	5	92
	71.12 Activities in the field of engineering, geology and geodesy, providing technical consulting services in these areas	22	2,587
	Other (71-75)	18	973
	Total	164	12,275

Source: Financial statements of MEs received at the request of CES, CES calculations

(continuation)

	Sector	Number of analysed MEs	Asset value (2019), UAH million
Development agencies and other	Separate decisions		
	Activities of head offices; management consulting	10	8,296
	Construction	23	6,514
	Public administration and defence; mandatory social insurance, including:	2	200
	84.11 General public management	1	171
	84.24 Activities in the field of public order and safety ("Kyiv Rescue Service")	1	29
	Education	4	99
	Forests and parks	4	66
	Arts, sports, entertainment and recreation	41	996
	Total	84	16,171

Source: Financial statements of MEs received at the request of CES, CES calculations

APPENDIX 2. INTERVIEW DESIGN

During March-May, 56 in-depth and expert interviews were conducted in 5 cities (Vinnytsia, Kyiv, Lviv, Odesa, Kharkiv) with the following groups of stakeholders:

- directors of MEs;
- heads of governing bodies of MEs (departments, management of local councils);
- members of local councils;
- activists and journalists;
- industry experts.

The format of in-depth interviews allows modifying the questionnaire during the interview and probing, depending on the experience and expertise of respondents. The main questions are listed below.

1. What purpose can the city have in owning municipal enterprises?
2. What is the mechanism for defining such a goal for newly created municipal enterprises?
3. In your opinion, what are the features of municipal enterprises compared to companies of other organisational and legal forms?
4. Briefly describe the advantages and disadvantages of enterprises of each ownership form for the community of your city.
5. What advantages and disadvantages does municipal ownership give?
6. What are the restrictions imposed by municipal ownership?
7. If you had the opportunity to transform municipal enterprises in your city into another organisational and legal form, would you take this opportunity? Why?
8. Would you agree to transfer municipal enterprises in your city to the concession? Why?
9. Would you agree to the privatisation of municipal enterprises in your city? Why?
10. How does the city, as the owner, exercise general control and supervision over MEs?
11. What is the procedure for electing directors of MEs in your city?
12. What do you think about such a procedure? Should something be changed?
13. What are the requirements for candidates for the position of directors of MEs?
14. Do you consider the remuneration of directors of MEs (salaries and other payments) competitive compared to private companies? Is it fair?
15. The law provides for the possibility of establishing supervisory boards (SBs) at municipal enterprises. Do such councils operate at municipal enterprises in your city?
16. What should be changed in the procedure of appointment, payment, exclusive powers of supervisory boards at municipal enterprises?
17. How would you classify municipal enterprises?
18. Does the local budget finance the municipal enterprises of each group? In what form?
19. Do municipal enterprises (accountable to you) participate in tenders of public and private enterprises? How often do they win?
20. Is there a risk of distorting competition if a municipal enterprise is involved in the procurement?
21. Is it possible to purchase services only from private players instead of municipal enterprises?
22. Is information about municipal enterprises in your city currently available?

APPENDIX 3. LIST OF RECOMMENDED LITERATURE

1. OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition https://www.oecd-ilibrary.org/governance/oecd-guidelines-on-corporate-governance-of-state-owned-enterprises-2015_9789264244160-en
2. Basic principles of implementation of ownership policy regarding economic entities of the public sector of the economy. <https://www.kmu.gov.ua/news/minekonomroztvitku-rozrobilo-politiku-vlasnosti-u-derzhavnomu-sektori-ekonomiki>
3. D. Yablonovskyy., O. Hamaniuk. Are the state owned enterprises less profitable than the private ones? <https://ces.org.ua/en/are-the-state-owned-enterprises-less-profitable-than-the-private-ones/>
4. D. Yablonovskyy., O. Hamaniuk. How to overcome corruption at the state-owned enterprises? <https://ces.org.ua/state-enterprise-corruption/>
5. B. Prokhorov, O. Lonevsky. How does financing of municipal enterprises impair competition <https://ces.org.ua/how-does-utility-financing-impairs-competition/>
6. D. Mykhailyshyna. Public Utility Companies: to Sell or to Keep? <https://voxukraine.org/en/public-utility-companies-to-sell-or-to-keep/>