

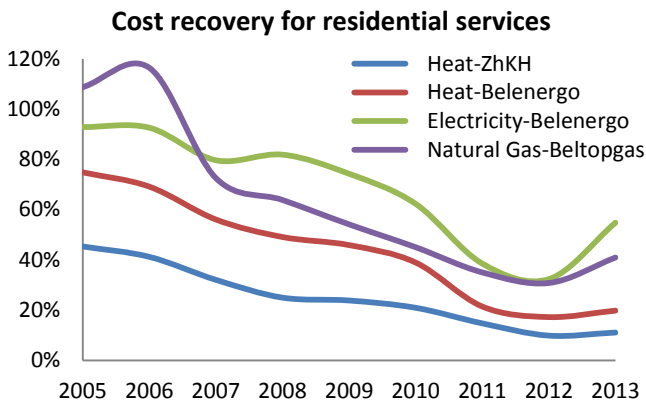


- *Despite nominal increases, residential gas, electricity, district heating tariffs have not kept pace with rising production costs, undermining financial viability of the utility sector.*
- *Low tariffs impose a large fiscal cost, disproportionately benefit wealthier households, discourage energy efficient behavior and undermine industry competitiveness by increasing the cost of energy for firms.*
- *Tariff reforms need to be sustained, accompanied by targeted social protection mechanism, systematic public communication and investments in energy efficiency.*

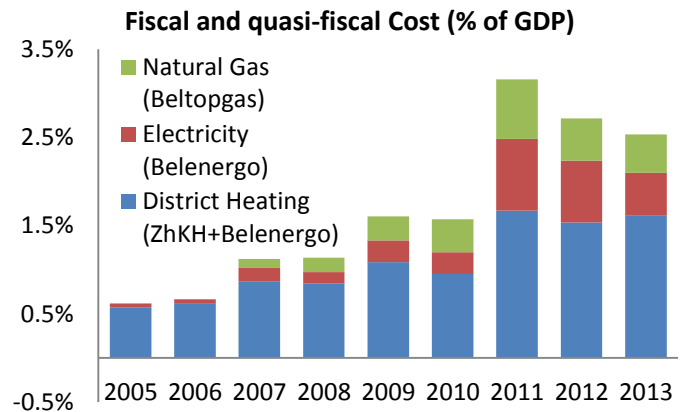
### Why are Tariff Reforms needed?

In Belarus, residential utility tariffs remain well below the cost of service. Since 2005 production costs for district heating, electricity and gas rose sharply as a result of increases in the import price of natural gas from Russia - the most important input for energy services - and BYR depreciation. In 2011, import price of gas increased from US\$47/tcm in 2005 to US\$263/tcm. This was followed in 2012 by a new energy agreement with Russia that lowered import price to US\$163/tcm. In 2013, gas import price increased marginally to US\$166/tcm. Even with these increases, gas import price for Belarus continues to be much below those for European importers. However, these favorable pricing terms were offset by a 64 percent of depreciation and high inflation during the 2011 balance of payment crisis. Nominal increases in residential tariffs did not keep pace with rising costs. As a result, residential utility tariffs were well below cost-recovery levels reaching alarmingly low levels by 2012. Tariff reforms implemented last year (doubling of electricity tariff, a 53 percent hike in gas tariff and a 17 percent increase in heating tariff) have started to reverse these negative trends. Despite these reforms, cost recovery levels, particularly in the heating sector, remain low.

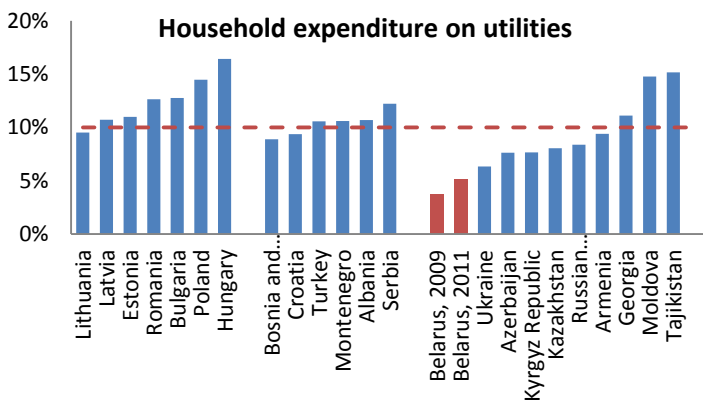
#### Tariff reforms have started to improve cost recovery, but more needs to be done



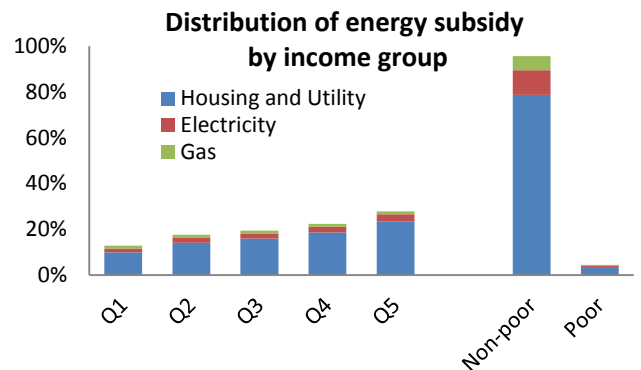
#### Energy subsidies continue to absorb significant resources



#### Energy subsidies have kept utility bills low...



#### ...but they benefit the wealthy



Source: World Bank Staff estimates based on official data.

**Energy subsidies impose large fiscal costs, benefit wealthier households more than the poor, discourage energy efficient behavior, and undermine industry competitiveness by increasing the cost of energy for firms.** Energy subsidies for households have increased fivefold since 2005 due to deteriorating cost recovery. Cumulative operating losses on residential electricity, gas and heat

sales amounted to an estimated US\$1.6 billion, equal to 2.5 percent of GDP in 2013. While municipal district heating companies (ZhKH) are largely compensated for their losses by direct budget subsidies from local governments, Belenergo does not receive subsidies from the budget and makes up shortfalls through cross-subsidies from electricity sales to industrial consumers. As a result, industrial consumers pay electricity tariffs far above cost recovery levels. About 1.4 percent of GDP is transferred through these cross subsidies from non-residential consumers to residential consumers. As such, they impose an implicit tax on the real sector, undermining the competitiveness of firms operating in Belarus while depriving utilities companies of the financing needed for routine maintenance and investment. Not only costly, energy subsidies are regressive and disproportionately benefit wealthier households that tend to have higher energy consumption. About 45 percent of energy subsidies flow to the richest 30 percent of the population. Moreover, energy subsidies distort price signals to households and lead to inefficient energy consumption patterns. Finally, by increasing dependence on underpriced gas imports they create macroeconomic vulnerability. Financial imbalances in the sector could escalate significantly if Belarus' gas import price were to rise to levels paid by European importers.

### ***What will be their impact?***

**Tariff reforms create fiscal savings.** Moving tariffs to full cost recovery would result in cumulative fiscal and quasi-fiscal savings equal to about 2.5 percent of GDP. Savings could be higher depending on gas import price, exchange rate, and inflation. These savings could be reallocated to different use, including targeted social assistance to mitigate the social impact of increased tariffs on poor and vulnerable households (see next paragraph), for investments in energy efficiency, or to allow for reductions in industrial utility tariffs. If social assistance and energy investments are well targeted, the reform is still expected to achieve significant net fiscal savings.

**While generating large fiscal savings, tariff reforms would have negative impacts on poverty and household welfare that need to be addressed.** Currently, households in Belarus spend on average less than 6 percent of their household outlays on utility bills, much lower than the average of 10 percent in countries in Europe and Central Asia. Higher tariffs will increase utility expenditures of households, especially the poorest who tend to spend higher shares of their income on utility bills. On average, household expenditures are estimated to rise to 11.4 percent of household income at full cost recovery tariffs. The impact would be most severe for the poorest households. The poorest 20 percent of households can be expected to spend, on average, 12.2 percent of their incomes on utilities if tariffs reach full cost recovery. The impact would be most acutely felt during the winter heating season when utility bills spike due to heating costs. To mitigate the impact of tariff increases and to avoid rising poverty, tariff reforms need to be accompanied by targeted social assistance to the poor and energy efficiency measures.

### ***How can they be implemented?***

**In line with stated Government objectives, tariff reforms need to be sustained to achieve cost recovery and eliminate direct and cross-subsidies over the medium term.** A well planned and sequenced tariff reform could comprise the following key reform elements:

- **Ensuring gradual, nominal tariff increases above cost inflation:** For tariff reforms to be effective in containing subsidies, nominal tariffs need to increase at a faster pace than the costs of production. It is therefore critical that tariff setting takes into account the impact of changes in gas import price, exchange rate and inflation on the cost of production and distribution of residential energy services. Once cost recovery is achieved, the current discretionary tariff setting process should be replaced by a formula driven process that would ensure that tariffs are automatically adjusted in line with changes in production costs.
- **Enhancing customer communications and engagement:** A comprehensive communications strategy aimed at explaining the rationale for tariff increases, coupled with efforts to improve governance, transparency and accountability of utility providers to improve services, can help reduce resistance to higher tariffs and engender user acceptance and support for the reform from consumers.
- **Improving social protection mechanisms:** Increasing tariffs will achieve substantial fiscal savings, part of which could be used to fund social protection mechanisms with better coverage and targeting to mitigate the social impact of higher tariffs on poor and vulnerable consumers. Some expansion of the existing targeted social assistance program (GASP), combined with a supplemental flat benefit on top of the regular GASP to those who pass the income threshold, would protect the poorest 20 percent while ensuring better targeting accuracy. Alternatively, households could be compensated for a share of the heating bill based on their per capita income through a housing and utility subsidy program. A refined formula would use an income test to determine eligibility and to differentiate benefit payments based on income levels. In addition, level payment plans—which allow customers to spread payments out evenly over the course of a year—may be an option for dealing with the seasonality of utility expenditure and higher utility bills during the winter months.
- **Invest in supply and demand-side energy efficiency:** On the supply side, savings can come from replacing older, low-efficiency boilers with newer ones; converting from natural gas to renewable fuels (such as biomass); replacing steam with hot water boilers; replacing networks to reduce losses; replacing pumps; and optimizing sizing of boilers and routing of networks. On the demand side, priority investments should be on replacement of central substations (CTPs) with individual substations (ITPs); building insulation measures (building enveloping and replacing windows); and apartment-level heat metering and regulation. Utility companies should be able to fund some of the supply-side investments through tariff revenue. The Government can also use some of the fiscal savings to invest in demand-side energy efficiency measures targeting low-income households.

