



Executive summary of the public audit report

## THE RENTING OUT OF HEATING SECTORS IN MUNICIPALITIES

10 March 2017, No. VA-P-30-2-5



Full audit report in Lithuanian available on website of the  
National Audit Office : [www.vkontrole.lt](http://www.vkontrole.lt)

## DEFINITIONS AND ABBREVIATIONS

---

**Renewable energy resources** – natural resources: potential water, solar, wind, biomass and geothermal energy.

**Biofuel** – flammable gaseous, liquid and solid products derived from biomass; forest and wood waste, straw, peat, agricultural waste, plants, biogas and other biologically derived fuel used for the production of energy.

**Investment** – financial investment and (or) legally assessed material, immaterial and financial asset, derived from a regulated activity, investment, invested in order to ensure long-term, reliable provision of a regulated service to the consumer at minimum cost, receive justified return and (or) income from the object of investment, and ensure the implementation of state-set tasks and (or) programmes.

**Cogeneration** (general heat and electric energy production) – the production of heat and electric energy within a single technological cycle.

**Rent** – the right to use and manage assets granted to a lessee by a lessor for a fee.

**Lessee** – a legal person who uses and manages assets transferred to it in accordance with a rent agreement.

**Lessor** – a legal person who had rented out its assets in accordance with a rent agreement.

**Regulating institution** – the National Commission for Energy Control and Prices or a municipal institution which, in accordance with the Law on Heat, were granted the right to control a respective entity's licensed activity or activities, the prices of which are regulated, and set the basic price for heat (price components).

**Basic price for heat** – long-term price for heat, calculated in accordance with the heat and hot water price-setting methods approved by the National Commission for Energy Control and Prices.

**Heat price regulation system (module)** – the totality of rules and procedures specified in legislation, which encompass the setting and control of prices for heat, and related changes to documentation. The system is composed of the National Commission for Energy Control and Prices, municipalities and subordinate heat provision companies, private heat suppliers and independent auditors.

**Heat supplier** – a person licensed to supply heat to consumers.

**The special plan of the heating sector** – a special municipal planning document, which defines the planned heat consumers' territories, and specifies potential and alternative means of heating. The purpose of the document is to meet the consumers' need for heat at minimum cost, without exceeding the allowed negative environmental impact.

**The heating sector** – an area of the energy sector, which is directly related to the production, transfer, supply and consumption of heat and hot water.

**Heat consumer** – a legal or natural person whose heating equipment is connected to heat transfer networks or a building's heat and hot water system in accordance with relevant procedure.

**Transfer of management** – the transfer of the right to manage the heating sector or its part to a person on the basis of rent, concession or other management transfer agreements.

**Public service obligations** – services provided by the heating sector, specified by law, the Government or its subordinate institutions in accordance with public interest.

**NCECP** – the National Commission for Energy Control and Prices.

## SUMMARY

---

More than 15 years ago, 14 municipalities had transferred the management of their heating equipment to private heat suppliers by entering into heating equipment rent (concession) agreements. The purpose of said agreements was to update and modernise the assets of the heating sector by attracting and implementing the necessary investments, and then return said assets back to the municipalities at the end of the rent period. The total sum of investment specified in the agreements was 240 million EUR. During recent years, as the heat sector rent agreements draw to a close, municipalities had commenced the taking over of their heat sectors. In late March of this year, the modernisation agreement of the heat sector of Vilnius, the largest heat sector in Lithuania, will come to an end.

Given that the supply of heat is a public service obligation, and the municipalities responsible for the organisation of said service do not have any experience in the take over of related assets from private subjects, and therefore run into various problems caused by insufficient monitoring of the implementation of agreements, we have decided to conduct an audit of the rent of heat sectors in municipalities.

The goal of the audit was to assess whether municipalities which either had taken over their heat sectors or plan to take them over, appropriately carry out the heat sector take over process, how they prepare for it, whether, in conducting the monitoring of the implementation of agreements, they ensure the achievement of the rent agreement goals and the appropriate take over of heat sectors.

In assessing the monitoring of the heat sector rent agreements implemented by municipalities, and their preparation for the take over of said sectors, we have assessed the following:

- whether municipalities are taking sufficient measures in monitoring the implementation of heat sector rent agreements, such that they would be more beneficial;
- whether municipalities are taking appropriate preparatory measures for the take over of their heat sectors at the conclusion of agreements, and how they implement it;
- whether preparations for the take over of the the heat sector of Vilnius are running smoothly;
- whether the new managers of the relevant heat sectors are selected appropriately.

Investments coordinated with municipalities in accordance with heat sector rent agreements have a significant impact on the price of heat. Since the lessee of the heat sector of the Vilnius municipality had unjustifiably included over 24.3 million EUR into the price of heat, we had also analysed the heat price control system (whether it ensures the determination of a justifiable price, and how the municipalities take part in this process).

The audit was carried out in municipalities which had already taken over the management of their heat sectors in 2015-2016 (the Prienai district and Palanga city municipalities), the Vilnius city municipality (where the take over is scheduled for 2017), the Telšiai district and other selected municipalities where the heat sector management terms have not yet expired. Given the goal of the audit, related procedures were not carried out in private heat supply companies, and no assessments were made regarding whether the lessees (private suppliers of heat) are fulfilling their obligations in accordance with the heat sector rent agreements.

The audit conclusions were formulated after an examination of the heat sector rent agreements and national legislation, which regulates the goals and functions of the heat sector, and the functioning of institutions responsible for implementing controls.

We have determined that, during the period of transferred management (rent) of the heat sector, the sum of investments made into the heat sector was in line with the sum specified in the agreements. Even though, in early 2016, the total sum of these investments was 210 million EUR<sup>1</sup>, due to a lack of experience, level of expertise or other reasons, municipalities had sometimes failed to ensure that the assets of the rented out heat sector would be managed in a manner conducive to the achievement of set goals and to receiving maximum benefits from the rent agreement – that is, the eventual take over of a modernised heat sector:

- the monitoring of the implementation of agreements carried out by the municipalities was ineffective: they were insufficiently active in the planning and coordination of investment to ensure that said investment be implemented in the most rational and beneficial manner and contribute to the development of a modern and effective heat sector, thereby taking into account the goal of updating the heat sector specified in the implemented agreements;
- in failing to implement sufficient controls regarding the implementation of agreements, municipalities had provided the lessees with the conditions for exploiting the infrastructure of their heat sectors and making part of the related assets their property. For this reason, municipalities may not recover all of their modernised heat sector assets once the agreements expire.

The insufficient monitoring of the implementation of agreements also has an impact on the inappropriateness of the take over of heat sectors once the agreements expire. Municipalities do not pay enough attention to the take over of the heat sector assets and fail to appreciate the relevant legal requirements, which leads to many cases where recovered assets are of lower value than they were at the moment of drawing up the agreement. Municipalities fail to sufficiently assess the condition of the recovered assets and ascertain the validity of the value of assets created by way of investment.

The heat price control system should be improved. The process of the determination of heat prices is strictly regulated, however, as evidenced by the violations identified in the actions of the lessee of the Vilnius city heat sector, the current heat price control system fails to ensure their validity. Furthermore, the system is highly complicated and insufficiently encouraging of municipalities and heat suppliers in improving their effectiveness and reducing prices.

During the period of the rent of the heat sector, due to the violations of the lessee in setting unjustified heat prices to the residents of Vilnius, and with the expiry of the agreement drawing near, the issue highly relevant to the consumers – which institutions are going to take what actions to recover the remaining part of the overpaid sums from UAB “Vilniaus energija”, in order to compensate consumers and protect the public interest – has not been settled in full. Since recovering overpaid sums is a difficult process, related to the interests of consumers and the implementation of the functions of several institutions, it is imperative that the Vilnius city municipality, the National Commission for Energy Control and Prices, and other institutions cooperate in deciding what actions to take next.

---

<sup>1</sup> The total sum of investments in seven selected municipalities in accordance with the data submitted by the municipalities themselves and their subordinate heat supply companies.

Municipalities whose heat sectors are currently being managed by private suppliers of heat should assess the contents of the present report and dedicate more attention to controlling the state and value of transferred assets, and the planning and implementation of investment: specify that, at the end of the transfer of asset management, the value of the assets to be taken over should be no lower than what it was at the moment of drawing up the agreement and establish clear rules for assessing said assets, as well as appropriate conditions for cases where the aforementioned requirement is not met. Attracting private investment into the heat sector can be beneficial both to municipalities and their residents, although that is only going to happen if the municipalities take an active part in the management of the heating sector both at the moment of drawing up the agreement and during its implementation. Municipalities should better represent their own interests and those of consumers and implement measures to prevent their violation (consult with relevant institutions, dedicate more attention to the planning of and compensation for investment, broaden their areas of expertise, consider the possibility of calling upon the offices of municipal control and auditing when implementing an agreement, etc.), and, if needed, protect their interests via legal means (by initiating changes to or the cancellation of agreements). Given the lack of controls regarding the manner in which the transferred heat sectors are managed and whether the goals of the heat sector agreements are implemented, the renting out of the heat sectors is unlikely to provide the maximum expected benefit to the municipality or the consumers of heat.

Having assessed the evidence collected during the audit, we present the conclusions and recommendations of the national audit. The implementation of the present recommendations would allow municipalities to ensure more effective monitoring of the management of their heat sectors, more fluent take over of said heat sectors once the rent period expires, and the implementation of improvements to the heat price control system, thereby ensuring the validity of said prices.

During the audit, the Prienai district municipality received a number of recommendations, but, given its refusal to implement them, the audit documents were transferred to the Prosecutor-General's Office of the Republic of Lithuania in order to protect the public interest. The matters determined in the Alytus city and Trakai district municipalities were submitted to the Special Investigation Service of the Republic of Lithuania, thereby allowing it to use its expertise in assessing the decisions made by the municipalities.

In order for the municipalities to take more decisive action to eliminate the violations identified during the audit and dedicate more attention to the assessment and implementation of the audit conclusions, the National Audit Office will continue to monitor how the municipalities implement the submitted conclusions and recommendations.

## CONCLUSIONS

### The monitoring of the implementation of the heat sector rent agreements

1. During the implementation of the agreements, municipalities fail to implement sufficient measures to ensure greater benefits related to the renting out of their heat sectors (Chapter 1):
  - 1.1. Municipalities are insufficiently involved in the planning and coordination of investment, which leads to occasional failure to assess the necessity of investment and the validity of its

price, and to investment not always being directed at the achievement of goals important to the municipalities (e.g., greater use of renewable resources). Not enough attention is dedicated to changes in the condition and value of assets. If municipalities were to more actively control the execution of investment and the condition and value of assets during the implementation of agreements, they would be able to ensure that, as the agreements expire, the heating sectors transferred back to them had been appropriately modernised based on beneficial investment implemented at minimum cost (Sections 1.1 and 1.3).

- 1.2. Municipalities fail to implement sufficient controls of the implementation of agreements, which has resulted in the lessees being provided with the conditions for exploiting the infrastructure of their heat sectors and making part of the related assets their property. For this reason, municipalities may not recover all of their modernised heat sector assets once the agreements expire. The Alytus city and Trakai district municipalities had allowed their lessees to exploit the infrastructure of the municipalities' heat sectors, invest into the modernisation of their boiler rooms and make them their private property. Such transfer of assets failed to conform to the interests of said municipalities. Furthermore, the principles of openness, transparency and competition were not applied (Section 1.2).

### The heat price control system

2. Even though the heat price control system is comprehensively regulated, contains the rules and procedures for setting prices, control measures, and involves the National Commission for Energy Control and Prices in the process of setting prices, it fails to ensure the validity of heat prices, is highly complicated and insufficiently encouraging of municipalities and heat suppliers in improving their effectiveness and reducing prices (Chapter 2):
  - 2.1. The heat price control system fails to ensure that the National Commission for Energy Control and Prices be provided with correct and reliable data necessary for setting valid heat prices. Special surveys carried out by the Commission had revealed significant violations conducted during earlier periods (e.g., a number of violations conducted by the lessee of the Vilnius city municipality's heat sector in 2012-2014 were identified in 2016), which necessitates making a decision regarding the issues related to compensating consumers for the money they had overpaid for heat.
  - 2.2. Due to the complicated regulation of pricing, a lack of experience, as well as other reasons, municipalities often fail to implement their duties, specified in the Law on Heat, to set the heat price components for the supplier of heat, or implement them inappropriately. In such cases, said components are unilaterally determined by the National Commission for Energy Control and Prices (in almost a third of municipalities in 2016). Some municipalities have now failed to set them for several consecutive years. It bears discussion whether a distribution of functions where prices are set both by the municipalities and the Commission (by recalculating the price components set by the municipalities) is rational, because both institutions have to assign resources to achieve the same result. Administrative load would be lower and the heat price control system would operate more effectively if municipalities and heat suppliers were encouraged to initiate decisions to improve the effectiveness of the supply of heat and lower heat prices.
  - 2.3. The risk related to the determination of unjustified heat prices is not lowered by legislation which specifies the obligatory auditing of heat suppliers regarding annual responsibility and

the conformity of accounting system data with the requirements set in the Heat Price Determination Methodology.

3. In September of 2016, the National Commission for Energy Control and Prices had concluded a survey which revealed that UAB "Vilniaus energija" had unjustifiably included over 24.3 million EUR into the price of heat in 2012-2014. Even though, after the setting of lower heat prices in December of 2016, part of these funds are now being returned to consumers, such compensations will only be implemented until the expiration of the Vilnius city heat sector rent agreement in late April of 2017. Furthermore, in accordance with the decision of the Supreme Administrative Court of Lithuania, the Commission will be obligated to assess the expenditures of UAB "Vilniaus energija" again and calculate heat prices, which means that if the Commission approves the new prices, yet another case of compensation of overpaid sums may have to be solved in the future. With the expiration of the agreement drawing closer, no decisions have yet been made on how to solve this questions of high importance to consumers – which institutions are going to take what actions to recover the overpaid sums from UAB "Vilniaus energija". Since recovering overpaid sums is a difficult process, related to the interests of consumers and the implementation of the functions of several institutions, it is imperative that the Vilnius city municipality, the National Commission for Energy Control and Prices, and other institutions cooperate in deciding what actions to take next (Chapter 2).

### The take over of heat sector assets

4. In taking over their heat sector assets from the lessees, municipalities fail to dedicate enough attention to the determination of the value and technical condition of assets, and ascertain the validity of said value, which leads to violations of both municipal and public interest:
  - 4.1. During the process of take over, municipalities fail to assess the technical condition of assets or take over assets which are in worse condition than they were at the moment of drawing up the agreement (e.g., punctured boilers are taken over which are unsuitable for use and have to be repaired) (Section 3.1).
  - 4.2. As rent agreement expire, municipalities fail to assess the value of the assets to be taken over, which in some cases leads to the take over of assets that are of lower value, thereby violating the Law on Heat. Not all municipalities protect their own financial interests because they fail to demand the lessee to compensate for asset-related losses that arise due to the lowered asset value. During the cancellation of the Prienai district heat sector rent agreement, the aforementioned law was violated because the residual value of the heat sector that was transferred back to the municipality was 1 million EUR lower than it was at the moment of drawing up the agreement (2.5 million EUR). The municipality failed to demand the compensation the asset-related losses that arose due to the lowered asset value (Section 3.2).
  - 4.3. Most heat sector rent agreements do not specify the requirement that the assets to be transferred back at the expiration of the agreement must be of no lower value than at the moment of drawing up the agreement. The agreements also fail to define the method of assessing (comparing) the value of the assets to be taken over (residual book value, market value, etc.). This increases the risk that as the heat sectors are taken over in the future, the failure to assess their value will result in the take over of assets of lower value, thereby violating the Law on Heat and failing to ensure the interests of both the municipalities and the consumer of heat (Section 3.3).



- 4.4. In taking over and paying for investments, which were not coordinated with municipalities at the time of the implementation of the agreements, municipalities fail to ascertain whether the information submitted by the lessees regarding the factual (residual) value of such investments is correct and justified. After prematurely terminating an agreement, the Prienai district municipality had agreed to take over and pay for the assets developed by way of investment at a 0.4 million EUR (plus VAT) residual value to the lessee in 36 months, but failed to ascertain the validity of the value of said assets (Section 3.4).
- 4.5. Municipalities fail to coordinate investments during the implementation of the agreements and, as the agreements expire, take over the updated assets not at the residual, but at the purchase value, i.e., in accordance with data which reflects neither the depreciation or the factual value of such assets during the take over. Since, for a long time (01 January 2005 to the expiration of the agreement on 31 May 2016), the Palanga city municipality did not coordinate the executed investments, the assets (3.3 million EUR) at the expiration of the agreement were taken over not at the residual, but at the purchase value (Section 3.4).
- 4.6. In certain cases, the lessees are compensated for their investments under conditions that are more favourable to them, without assessing the decrease in the value of the assets to be taken over – the Prienai district municipality had committed to compensate the lessee for the implemented investments, but failed to consider the fact that the assets transferred back by the lessee were of lower value than at the moment of drawing up the agreement (Section 3.4).

With municipalities failing to assess the technical condition of their assets and taking over assets of lowered value, the goal of the heat sector rent agreements to modernise the heat sectors is not achieved. As municipalities fail to assess the value of the assets to be taken over and lessees submit incorrect data, compensation for investments may be implemented inappropriately, which may result in unjustified expenses on the part of the municipalities and their subordinate heat supply companies. Furthermore, the value of the transferred assets have an impact on the heat price – since expenditures related to investments are included into the price, the take over of assets at an incorrect value raises doubt regarding the validity of heat prices set on the basis of such investments and the assurance of the consumer interest.

### The take over of the Vilnius city heat sector

5. Even though the Vilnius city municipality company AB “Vilniaus šilumos tinklai” had commenced preparations for the take over of its heat sector in advance, approved the asset take over plan and started to implement it, the appropriate and fluid take over process is being hampered by a lack of information on the implemented investments and the condition of the assets, and disagreements between the lessee and the municipality. This risk could have been managed if, during the implementation of the agreement, the municipality would have dedicated more attention to the management of investments and assets, and the monitoring of the condition of the rented out assets (Chapter 4).
6. According to the municipality, event though the entire sum specified in the agreement was invested into the heat sector of Vilnius during the period of the agreement, the municipality is raising questions regarding the validity of the value of transferred investments due to the insufficient maintenance of the heat sector. Although the agreement had specified the modernisation of the heat sector, the failure to make sufficient investments into renewable energy resources during the implementation of said agreement had resulted in only about 30 percent of the energy being generated by using biofuels, whereas in most other municipalities the use of

biofuel accounted for 50-100 percent of the generated energy. As the agreement expires, part of the assets to be taken over will fail to meet today's environmental requirements, which means the municipality will require investments to modernise its heat sector (Chapter 4).

7. The modernisation of the heat sector of Vilnius is a national priority. Even though the Government has approved the implementation of the Vilnius cogeneration plant project, which will have a significant effect on the heat sector of the region, the municipality is not making the decisions necessary for the implementation of said project. A closer partnership between the Vilnius city municipality, UAB "Lietuvos energija" and the Ministry of Energy would ensure more effective modernisation of the heat sector of Vilnius and more consumer-friendly decisions (Chapter 4).

### The selection of the new manager of the heat sector

8. The process of selecting the new manager of the heat sector fails to ensure its proper implementations (Chapter 5):
  - 8.1. In 2016, with the heat sector modernisation and renovation agreement of the year 2000 drawing to a close, the Telšiai district municipality had approved the tender conditions and announced a heat sector rent and investment tender without implementing any of the procedures set in the laws on investment and concessions. This case shows that municipalities do not know how to organise a heat sector rent tender, which means that the future transfer of assets to the new manager may be implemented by violating legal requirements.
  - 8.2. In accordance with the Law on Heat, when drawing up heat sector transfer requirements, municipalities must consider the conclusions of the Minister of Energy, however, the Ministry of Energy is yet to approve the procedure or criteria for the assessment of such agreements to be able to authoritatively assess the agreements submitted by the municipalities.

## RECOMMENDATIONS

In order for the management of municipal heat sectors to be more beneficial, to better meet the interests of consumers, to avoid future mistakes in monitoring the management of heat sectors, heat sector take over or the transfer of its management to private heat suppliers, and to improve the operation of the heat price control system, we present the following recommendations.

### To the Government of the Republic of Lithuania

1. Consider different alternatives for the change or improvement of the current heat price control model and initiate changes to relevant legislation, which would result not only in the decrease in regulatory administrative load and the assurance of the validity of prices, but also in the motivation of its participants to function more effectively and implement innovative solutions, which would allow them to strive for the lowest possible prices for consumers of heat (Conclusion 2). Improvements to the price control system should also consider potential measures of improving the reliability and management of the information necessary for calculating the heat prices:
  - The National Commission for Energy Control and Prices should be granted more authority in receiving the information necessary for ensuring its functioning, and stricter sanctions should be implemented for the failure to provide such information;

- The input of independent auditors in implementing audits of the expenditures of activities licensed by the suppliers of heat should be increased.

### To the Ministry of Energy of the Republic of Lithuania

2. In order to implement the function set for the Ministry by the Law on Heat – providing municipalities with conclusions regarding the drawing up of heat sector transfer agreements – develop and approve a procedure for the provision of municipalities with conclusions regarding the heat sector management transfer agreements. Specify the stage of the transfer of heat sector management when submissions regarding the provision of such conclusions should be made, and clear agreement assessment criteria (Conclusion 8.2).

### To the Vilnius city municipality

3. Cooperate with the National Commission for Energy Control and Prices and other institutions in discussing and specifying measures for recovering the sums overpaid by the consumers of heat from UAB “Vilniaus energija”, thereby protecting the public interest and compensating consumers for overpaid sums (Conclusion 3).

### To the Alytus city municipality

4. Assess the effects of the actions of UAB “Litesko” and UAB “Fonas” on the modernisation of the heat sector of Alytus and the purchase of the boiler room rented by UAB “Alytaus šilumos tinklai” (address: Pramonės Str. 9, Alytus), and consider the possibility of initiating clarifications to the lawsuit submitted to the court or implementing other measures to protect the public interest (Conclusion 1.2).

### To the Trakai district municipality

5. Assess the actions of UAB “Trakų energija” which had led to violations of the law and this company becoming the owner of the biofuel boiler room and its attachments in Lentvaris, and implement measures to protect the public interest (Conclusion 1.2).

The terms and measures for the implementation of recommendations are presented in the Recommendation Implementation Plan.