

ACTION FICHE UKRAINE

1. IDENTIFICATION

Title	Support to the implementation of Ukraine's Energy strategy ENPI/2007/18788		
Total cost	<i>€87 million (EC contribution, including €22m related to Energy Efficiency and renewables allocated from the Governance Facility) Other expected contributions: EIB / EBRD: €400 million; World Bank DPL-2: \$150 million</i>		
Aid method / management mode	– Sector budget support, non targeted (centralised management) – Project mode for related technical assistance (direct centralised management).		
DAC-code	23050	Sector	Gas distribution

2. RATIONALE AND COUNTRY CONTEXT

2.1. Economic and social situation

Basic existing preconditions

The three basic pre-conditions for implementing a sectoral energy support programme are currently met:

- there is a Government strategy for the sector whose objectives and principles are converging with those of the EU
- there is an active policy dialogue between the Government and the EC on energy related issues
- a monitoring mechanism of the co-operation outcomes has been put in place.

Macro-economic policy and Public finance management

The Annual Action Programme provides extensive information with respect to Ukraine's macro-economic situation and Public finance management system.

2.2. Cooperation policy of beneficiary country

Ukraine-EC energy cooperation is based on the Energy chapter of the Action Plan and the Energy MoU¹. It has gained considerable momentum in 2006, thanks to a structure of sub-sectoral monitoring groups.

2.3. Government Sector Programme

A clearly defined framework for cooperation between the European Union and Ukraine in the energy sector, including objectives, deadlines and priorities, has been set out in the Energy MoU and the Aide-Mémoires signed between the Commission and the Ukrainian

¹ Memorandum of Understanding between Ukraine and the European Union on enhanced co-operation in the field of energy of 1 December 2005.

Energy Ministry in September and October 2006. In the three areas of direct concern to this cooperation, this framework will be complemented in the first months of 2007 with area-specific work plans currently under discussion.

Obvious convergence of the Energy MoU and the Ukrainian Energy strategy 2005-2030 released on 23 March 2006 guarantees ownership of the programme by the Ukrainian stakeholders. The Government is currently preparing a PFM reform, with technical assistance of the World Bank. This reform plan, which should involve the Ministry of Finance, the State Treasury and the Control and Revision Unit (KRU) is expected to be finalised soon for implementation over the period 2007-2009.

2.4. Lessons learnt

It will be the first time in Ukraine that an EC sector support operation will be launched. Therefore, there are no lessons learnt available in the country. World Bank experience in the sector as well as in budget support, however, will be taken into account during the formulation and implementation phases.

2.5. Complementary actions

Ukraine has started from 2007 an intensive energy sector rehabilitation and modernisation programme, that it intends to finance mainly via borrowings on the domestic or the international market, under the coordination and supervision of the Deputy Prime Minister for Infrastructure.

This programme in support of the energy strategy of the Ukraine is complemented by planned EIB/EBRD loan packages (under EC co-ordination) to be signed within the framework of EIB's first Ukraine mandate (before 31 July 2007) and to be followed by further lending operations to modernise the energy sector in relation with the objectives of the Energy MoU.

Complementary Tacis projects include a recently started support to prepare Ukraine to integrating the electricity trans-European networks and a forthcoming project in support of coal sector reform.

The World Bank is preparing a part on energy sector reform in its forthcoming DPL-2 operation.

2.6. Donor coordination

2.6.1. Energy: The Government has recently established a Government-led coordination mechanism, which includes thematic working groups, each co-led by a Government agency and a "lead donor". An Energy sector working group (Thematic group E) convened on 23 November 2006 (under EBRD co-leadership) and again on 27 February 2007 (under EC co-leadership). In addition, frequent working contacts of the EC Delegation with the World Bank, the EBRD and smaller donors involved in the energy efficiency segment (Denmark, Sweden, NEFCO) provide guarantees of cohesion and coordination of efforts.

2.6.2. Public Finance Management: Several donors are involved in assistance to the PFM reform. The PFM reform strategy and Action Plan are being prepared by the Government with technical assistance of the World Bank. Besides the World Bank and the European Commission, contributions in the form of technical assistance are made by France, the Netherlands, Canada, the United Kingdom and Sweden.

Donors' activities in the field of PFM are rather well coordinated. This coordination is carried out both at the level of the donors' coordination groups established under the Ministry of Economy and on a bilateral basis.

3. DESCRIPTION

3.1. Objectives

The objectives of the government strategy are to modernise Ukraine's energy sector with a view to making it sufficient to support Ukraine's rapid economic growth, and a net exporter of secondary energy (aiming primarily at the EU market). This involves the reduction of the economy's energy intensity (from 89 cents per Euro of GDP in 2005 to 41 cents in 2030), and to develop Ukraine's capacity as a transit country for energy resources.

The objective of the measure is to reinforce EU-Ukraine energy co-operation for the implementation of the energy chapter of the Action Plan for Ukraine, which targets primarily integration of Ukraine into the EU Single Energy Market and reliability of Ukraine as a transit country for the purpose of energy supply security.

3.2. Expected results and main activities

Implementation by the Government of Ukraine of an overall energy policy converging towards EU energy policy objectives, which implies:

- Gradual convergence of the relevant Ukrainian laws and regulations towards the principles of the EU internal electricity and gas markets
- Development of gas and oil transport infrastructure allowing for diversification of supplies, as well as increased performance and improved safety and security of the gas transit network
- Restructuring of the solid fuel mines
- Progress on energy efficiency and the use of renewable energy sources
- Enhanced nuclear safety

Results expected from the Government's strategy to be encouraged by the measure comprise:

- Sub-sectoral energy policy documents are prepared and adopted by the appropriate instance
- Measures for gradual convergence towards the principles of the EU internal electricity and gas markets are established. These measures are accompanied by a time schedule, a financing plan and are implemented (implying further restructuring of the gas and electricity markets)
- A law developing the National Electricity Regulatory Commission is adopted and implemented
- Ukraine participates in EU related energy events including a gradual involvement in the European Gas and Electricity Regulatory fora
- Infrastructure allowing diversification of oil and gas supplies are developed; the legal structure, performance, safety and security of gas transit is improved
- A feasibility analysis of electricity interconnection of Ukraine with the UCTE synchronous network is carried out
- The coal sector restructuring plan is further implemented, including implementation of clean coal technology
- Action plans for improving energy efficiency and enhancing the use of renewable energy are adopted
- The Memorandum of understanding on the closure of the Chernobyl nuclear power plant (NPP) is fully implemented and Ukraine complies with the internationally accepted nuclear safety standards

- The State Nuclear Regulatory Committee of the Ukraine is further strengthened
- Measures are taken to ensure the entry into force and implementation of the agreement concluded with Euratom on peaceful uses of nuclear energy
- A national nuclear waste strategy is adopted.

The proposed action will target specifically:

- The long-term security of hydrocarbons transit through Ukraine
- Energy efficiency and promotion of renewable energy sources
- The integration of Ukraine into the EU Single Energy Market.

3.3. Stakeholders

The main national institutions involved in the implementation of the energy component of the programme are the Ministry of Fuel and Energy, the national company Naftohaz of Ukraine and its subsidiaries, the National Agency for Energy Efficiency, the National Electricity Regulatory Commission, to which a number of research institutes of the National Academy of Sciences could be added in the course of project preparation².

The Ministry of Finance will provide information on progress in the implementation of the PFM reform plan.

The Ministry of Economy, coordinator of the European Commission activities in Ukraine, will be closely associated to the management of the programme.

These institutions generally need assistance to build up their institutional capacity to refine, maintain, and monitor a national reform and development strategy for the energy sector, properly integrated with other sectoral strategies. External capacity building support could be provided, notably via twinning projects.

3.4. Risks and assumptions

Assumptions

- Ukraine is willing to conduct a policy dialogue with the European Union and other interested donors on the issue of PFM reform.
- Ukraine will keep to all of its commitments under the ENP Action Plan and the Energy MoU, and will continue demonstrating heightened interest in the proposed cooperation.
- Ukraine will not substantially revise the principles underlying its national energy strategy, and its government will be willing to follow the foreseen reform path, translating it into concrete policies.

Risks

- One or several of the ministries, agencies or companies involved in the programme might either be reluctant or not have the capacity to cooperate in an ordered manner. This risk can be mitigated via the use of established Energy MoU dialogue mechanisms and the provision of adequate technical assistance.
- Part of the activities (such as the audit of the hydrocarbons transportation systems) will be governed under specific secrecy legislation. This aspect will be carefully considered during the formulation phase, and when designing the disbursement benchmarks.

²

Meaning those institutes which have been involved in developing the national energy strategy and are likely to take part in its monitoring, in concurrence with Energy MoU monitoring.

- The financial situation of Naftohaz of Ukraine deteriorates to a point that it affects the financial and operating capacities of its subsidiaries in charge of the gas and oil transportation systems. As a mitigation measure, the IFIs will focus on Naftohaz’ subsidiaries, in order to limit the impact of their contemplated lending operations on Naftohaz’s creditworthiness.

3.5. Crosscutting Issues

The cross-cutting issues of good governance and human rights, as well as environment are clearly integrated into the proposed programme, through:

- The alignment of market regulations with EU norms, including in the areas of access to energy and energy tariffs for the population
- The progressive reform of the hydrocarbons transit systems (to be progressively unbundled as required by the relevant EU Directives)
- The importance given to energy-efficiency actions leading to reduced environmental impact of the energy infrastructure’s operation

At this stage, the proposed programme has no identified impact on gender equality.

4. IMPLEMENTATION ISSUES

4.1. Implementation method

The programme will be untargeted budget support under centralised management. Funds will be channelled to the State Treasury.

Provision of a technical support will also be included in the programme and will be implemented via technical assistance. This € 5 million package will ensure proper follow-up of implementation, report on the evolution of the energy and PFM sectors, and provide for specific advice to facilitate achievement of critical Energy MoU objectives and programme benchmarks.

4.2. Procurement procedures

For the technical assistance component, the contracts implementing the action must be awarded and implemented in accordance with the procedures and standard documents laid down and published by the Commission for the implementation of external operations, in force at the time of the launch of the procedure in question.

All programme estimates must respect the procedures and standard documents laid down by the Commission, in force at the time of the adoption of the programme estimates in question.

4.3. Budget and calendar

Indicative breakdown of overall amount by main component:

- | | | |
|--|---|------------|
| – Budget support: | € | 82 million |
| – Related technical assistance to the Energy sector: | € | 5 million |

Budgetary support is expected to be disbursed in two tranches: a fixed tranche of €40 million in the first quarter 2008, and a second tranche of €42 million in the first half of 2009.

The programme will in principle be implemented within three years after the first budget tranche has been released.

Signature of the Financing Agreement between the European Commission and the Government of Ukraine shall create the condition for disbursement of the first instalment. Assuming that signature of the agreement takes place before the end of 2007, and early enough for inclusion of the Commission grant into the State budget revenues for the fiscal year 2008, disbursement of the first instalment will take place during the first quarter of 2008.

As regards the disbursement of the second instalment, actual achievements will be compared to preliminary agreed benchmarks (see section 4.4). €11m of the €22m linked to energy efficiency and renewable energies will be included in the first instalment, while €11m of the second instalment will be dependent upon benchmarks related to energy efficiency and renewable energy.

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Further support to the implementation of the MoU on Energy might be envisaged over the next years, subject to relevant Commission Decision.

4.4. Performance monitoring and criteria for disbursement

4.4.1. Performance monitoring will be exerted by a Joint monitoring group whose basis has been laid down in August 2006 with the establishment of the Energy MoU monitoring group partnering the Ministry of Fuels and Energy and the European Commission. The larger Joint monitoring group will rely on official information provided by Ukraine and verified as appropriate by the ad-hoc Advisory group currently being established at the Ministry of Energy.

The monitoring mechanism foresees the production of half-yearly joint EU-Ukraine progress reports, which are based on reports delivered by the five working groups established to monitor the implementation of the MoU.

This mechanism will be used to monitor the implementation of the budget support programme. Since disbursement of budget support instalments is contingent on Ukraine meeting benchmarks, the monitoring reports will include an assessment of these benchmarks. Information requested for this assessment, including information relative to progress of the PFM reform, will be provided by the GoU.

4.4.2. Criteria for disbursement: Performance indicators will be defined during the second quarter 2007. They would typically include:

- General conditions such as:

The Government of Ukraine implements a macroeconomic and financial policy conducive to strong and sustainable economic growth and demonstrates commitment to implement the measures of the EU-Ukraine Action Plan related to macro-economic policy (article 19 of the AP);

The Government of Ukraine demonstrates commitment to implement the EU-Ukraine Action Plan measures related to public procurement (article 42) and financial control (article 44);

The Government of Ukraine demonstrates commitment to implement the EU-Ukraine Action Plan measures related to energy (articles 51 to 57).

- Energy-related benchmarks and indicators:

will concern the three areas of electricity and gas markets regulation, security of energy supplies and transit of hydrocarbons, and energy efficiency. They will be determined before the start of the project as well as specific benchmarks, such as the audit of the existing hydrocarbon transit and supply network with a view to developing a modernisation and infrastructures master plan (section 3.4 (a) of the Energy MoU).). €11m of the €22m linked to energy efficiency and renewable energies will be included in the first instalment, while €11m of the second instalment will be dependent upon benchmarks related to energy efficiency and renewable energy.

- PFM-related benchmarks:

will be defined in line with the objectives set forth in the government strategy to be adopted soon with World Bank support. Impact indicators and outcome indicators will be set up according to the timetable set by the GoU in the Action Plan for implementation of the PFM reform.

4.5. Evaluation and audit

The measure will be subject to regular monitoring by the Joint monitoring group. A mid-term evaluation will be organised to check the overall validity of the monitoring system and of the disbursement criteria for the next tranches.

4.6. Communication and visibility

Proper communication and visibility of the action will be achieved via regular joint communication events on the occasion of the achievement of the disbursement criteria, as well as in connection with the results of technical assistance projects in the energy sector. A reasonable communication budget will be set aside for promotion of the measure.

