

**DOCUMENT OF THE EUROPEAN BANK  
FOR RECONSTRUCTION AND DEVELOPMENT**

**STRATEGY FOR UKRAINE**

As approved by the Board of Directors on 18 September 2007

## LIST OF ABBREVIATIONS

AAU	Assigned Amount Units
AIDS	Auto Immune Deficiency Syndrome
BAS	Business Advisory Service
CEE	Central and Eastern Europe
CIDA	Canadian International Development Agency
CNG	Compressed Natural Gas
CPI	Consumer Price Index
CSF	Chernobyl Shelter Fund
EBRD	European Bank for Reconstruction and Development
ESCO	Energy Saving Company
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FI	Financial Institution
GDP	Gross Domestic Product
GHG	Greenhouse Gases
GIS	Green Investment Schemes
HIV	Human Immunodeficiency Virus
IEA	International Energy Agency
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
JI	Joint Implementation
K2	The second reactor at Khmelnytsky Nuclear Power Plant
LPG	Liquefied Petroleum Gas
MCCF	Multilateral Carbon Credit Fund
MIS	Management Information System(s)
MSE	Micro or Small Enterprise
MSME	Micro, Small or Medium sized Enterprise
NAEE	National Agency on Energy Efficiency
NAK	Ukraine Naftogaz
NBU	National Bank of Ukraine
NPP	Nuclear Power Plant
NSA	Nuclear Safety Account
OECD	Organisation for Economic Cooperation and Development
OSCE	Organisation for Security and Cooperation in Europe
PB	Participating Banks
PPP	Purchasing Power Parity
R4	The fourth reactor at Rivne Nuclear Power Plant
SME	Small or Medium sized Enterprise
TAM	Turnaround Management
TC	Technical Co-operation
UAH	Ukrainian Hryvnia
UKEEP	Ukrainian Energy Efficiency Programme
UMC	Ukrainian Mobile Communications

UMLP	Ukraine Micro Lending Programme
UMTS	Universal Mobile Telecommunications System
UNECE	United Nations Economic Commission for Europe
USD	United States Dollar
VAT	Value Added Tax
WHR	Warehouse Receipt
WTO	World Trade Organisation

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## **EXECUTIVE SUMMARY**

Ukraine is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank.

During the past two years Ukraine's democratic political transition has progressed on many fronts. Some important political institutions have been strengthened and have placed the country on a course toward a European-style representative democracy. The parliamentary election of March 2006 was deemed free and fair by international monitors and was characterised by a lively campaign and genuine political competition. Another positive development is the improvement in media freedom and civil society development. These are notable achievements; however, they must be balanced against the still sizeable challenges Ukraine faces in building a unified, law-governed democratic state. First among them is the need to strengthen the judiciary and courts system and reduce corruption. Democratic consolidation will take time. Achieving it will entail converting the broad consensus in pro-European values, which is evident in society as well as in the agendas of the major political parties, into a workable programme of political and economic reform. At the top of the agenda is the need to clarify the respective powers of the President, the Cabinet and the Parliament, as contained in the amendments to the Constitution which went into effect in 2006. Ongoing disputes over the meaning and intent of these changes have resulted in political stalemate and have placed limits on policy effectiveness.

Nevertheless, Ukraine's overall progress in transition to democracy has had a positive impact on investor sentiment and some aspects of the business environment. Over the last two years Ukraine has experienced a strong increase in foreign direct investment, including market entry by several foreign financial institutions. Significant progress was made in the negotiations to join the WTO. The economy has rebounded from the temporary slump that followed the Orange revolution. Real GDP growth was an estimated 7.1 per cent in 2006, compared with 2.6 per cent in 2005. Contrary to the past, when growth was export-led, domestic investment and private consumption, fuelled by credit growth and generous increases in wages and pensions, became the key drivers of growth in 2006. The economy showed a high degree of resilience to higher energy prices, absorbing a near-doubling in the price of gas imported from Russia since 2005.

However, many long-term challenges and short-term economic risks remain. The rapid growth in foreign currency lending and rising private external debt, albeit from a low base, pose strains on the still under-developed financial system. At the same time, access to capital, both equity and debt, remains a constraint to many enterprises. If protracted, the current turbulence in Western financial markets, with lower global liquidity and decreased appetite for risk, may have a negative impact on Ukraine growth in the medium term, as bank lending may slow down and companies may face difficulties in financing their ambitious modernisation programmes, with negative repercussions on domestic consumption and investment. The economy is also vulnerable to a sharp terms-of-trade shock, which may be triggered by either swings in metals prices, Ukraine's main export commodity, or further increases in energy import prices. In the long-term, the gradual convergence of domestic energy prices to

international levels may act as a catalyst for industrial sector restructuring and energy efficiency improvements, as Ukraine is one of the most energy intensive and inefficient economies in the region.

The Ukraine economy is thus facing important structural and economic challenges in the years ahead, which the Bank stands ready to support with its operations over the next strategy cycle. The key transition challenges will be how to:

- **Diversify the production base and improve the country's competitiveness**, in response to increased pressures coming from external suppliers, as the country is expected to join WTO in the near future and start negotiations on an extended free trade agreement with the EU shortly thereafter. Achieving these goals will require further economic diversification (metallurgy and metal processing account for more than a quarter of total industrial production and about 40 per cent of total exports) and market liberalisation, limiting the use of administrative controls in the economy. To fully reap the benefits of greater trade and economic integration with the world economy, significant investment will also be needed to overcome infrastructure and transport bottlenecks.
- **Improve access to capital by developing local capital markets**, to meet the increasing financing needs of the corporate sector. Ukraine's financial sector experienced profound changes over the past two years. While financial intermediation is deepening, helped by the entry of major foreign players into the banking system, information disclosure, transparency over ownership and opaque lending practices in smaller banks remain a concern. The development of a domestic capital market is still at an early stage and is hampered by the poor protection of minority shareholders rights and lack of appropriate legislation to regulate issuance and trading of derivatives. The existence of burdensome currency regulations on investment by foreigners, weak regulatory frameworks for mortgage, leasing and factoring services and delays in the implementation of pension and health care reforms are further obstacles to the development of non-banking financial institutions.
- **Press ahead with energy sector reform**, by reducing cross-subsidisation among different categories of consumers and ensuring cost-recovery tariffs to stimulate investment and promote energy efficiency measures, promoting private ownership or operation of energy assets and strengthening the independence of the National Electricity Regulatory Commission.
- **Strengthen corporate governance and transparency**, by improving company law, advancing judicial reform, reforming the public administration and creating a playing level field for all private investors. The resale of Kryvorizhstal, Ukraine's largest steel mill, to Mittal Steel in October 2005 raised the standards for future large-scale privatisations in the country. However, there is still some way to go before a stable and transparent tax and business regulatory framework is in place in Ukraine.

In the face of these challenges, the main operational priorities of the Bank for the next Strategy period will lie in:

- promoting higher efficiency, competitiveness and corporate governance standards in the local private sector and assisting foreign direct investment;
- promoting the development of the domestic capital markets and providing continued support to micro, small and medium-sized private enterprises through dedicated long-term credit lines with partner banks.
- promoting energy efficiency and security, environmental protection and sustainable use of natural resources throughout all sectors of the economy;
- improving efficiency and reliability of key infrastructure, power generation, transmission and distribution and of the oil and gas transport systems of Ukraine.

In the corporate sector, the main focus will be to support **local companies** in their drive to improve overall competitiveness, energy efficiency, productivity, corporate transparency and environmental performance. The Bank will also support the increasing flow of **foreign direct investment** which has a high demonstration effect in terms of good corporate governance, introduction of modern know-how and higher environmental standards.

In the light of increased energy prices and low energy efficiency in Ukraine, the Bank will reinforce its **energy efficiency** initiatives in all sectors of the economy: both through direct lending in the corporate, power and infrastructure sectors and through an expansion of intermediated lending within the framework of the industrial energy efficiency credit lines and the structuring of new residential energy efficiency credit lines.

In the **financial sector**, the Bank will encourage foreign investment as a means of strengthening the capital base of the sector as well as increasing competition. In order to help improve the stability of the banking sector and its ability to fund the real economy, the Bank will continue to provide long term funding to local banks. The Bank will seek to develop local currency financing instruments based on the approach used already in Russia and other countries as a means to encourage local currency borrowing by corporates and consumers. Through its local currency program the Bank will also aim to give an impetus to the development of the local capital markets and the use of money-markets derivatives.

In the **power and energy sector** of Ukraine, the Bank will help support the implementation of the MoU on EU-Ukraine cooperation in the field of energy (of 1 December 2005) which is the cornerstone of EU-Ukraine cooperation on energy. In particular the Bank will assist the modernization and rehabilitation of the main trans-European energy networks of Ukraine. It will invest in modern and energy efficient generation, transport and distribution of energy. The Bank will also support the diversification of supply sources and promote alternative fuels. These aims will be complemented by support to reforms in the energy sector to develop further its liberalization and promote private sector involvement.

In the area of **nuclear safety**, a major challenge for the Bank will be to improve the standards of nuclear safety at existing NPPs, the safe decommissioning of Chernobyl NPP and the creation of a safe confinement for its Unit 4. The government will need to continue to ensure a supportive institutional environment.

The Bank will support the improvement of Ukraine's transport and communications infrastructure which is key to the country's competitiveness and its integration into European transport networks and the world economy. The focus will be on the development of the TRACECA corridor and the other main transport corridors in Ukraine and their interconnections to the Trans-European Transport Networks aiming to facilitate the transportation of goods and passengers, as recommended by the High-Level Group on the extension of the main trans-European transport axes to neighbouring countries as well as by the Long-Term TRACECA Strategy up to 2015.

In the **municipal sector** the Bank will focus on financing energy efficiency in district heating, water/wastewater, solid waste and public transport investments in large and medium-sized cities. In the preparation of municipal projects, the Bank will promote institutional reforms and corporatisation of municipal utilities, financial and operational performance improvements and full cost recovery through tariffs, taking into account affordability constraints.

Given Ukraine's enhanced role as one of the key neighbours of the enlarged EU, the Bank will support the implementation of the external mandate of the EIB in Ukraine and the European Neighborhood Policy noting in particular the Memorandum of Understanding between the European Commission, in liaison with the European Investment Bank and the EBRD signed in December 2006. In particular, the Bank will actively co-finance projects with the EIB in accordance with agreed principles and in accordance with the EIB external mandate.

What the Bank can achieve under the proposed Strategy is contingent on the progress in reforms in the coming years. It is hoped that the Government of Ukraine, in addition to its ambitious public infrastructure investment program, will show a strong commitment to further reforms in the corporate, capital markets, tax and justice areas.

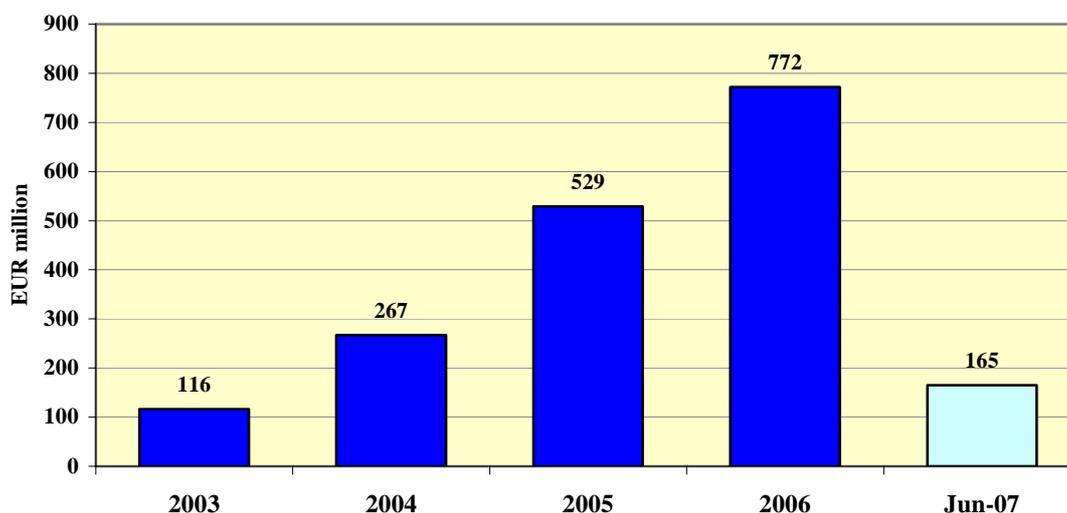
## 1. THE BANK'S PORTFOLIO

### 1.1 Overview of Bank Activities to Date

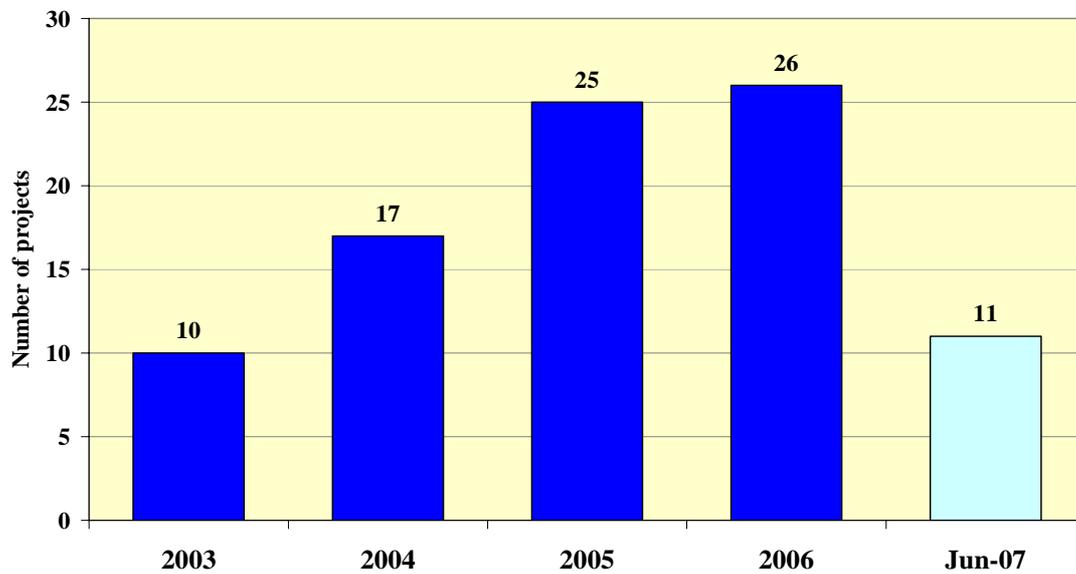
During the strategy period Ukraine rose to become the Bank's 3<sup>rd</sup> largest exposure (after Russia and Poland), representing approximately 8.7% of the Bank's signed commitments as of 31 December 2006. This is significant in as much as during the two previous strategy periods Ukraine was ranking fifth in terms of exposure. As of 31 March 2007 the Bank had invested in 96 projects with a net cumulative business volume (the "NCBV") of EUR 2,896 million, with private sector projects representing 72% of the NCBV and non sovereign operations representing 67% of the NCBV. In terms of the sector distribution of Bank financing, 31% of the portfolio is in Infrastructure, some 21% in General Industries, 20% in Specialised Industries (mostly Agribusiness), 20% in Financial Institutions and the balance of 8% in Energy. In terms of number of projects, the greatest number (32) is in Specialised Industries, Financial Institutions having 23 and the other sectors each between eight and 19 projects.

Over the period of the last Country Strategy, the new annual commitments of the Bank showed a strong growing tendency. Throughout this period (2005-2006) annual commitments in Ukraine were the second largest in the Bank's countries of operation after Russia reaching €772 million in 2006 (see Chart 1). The annual number of new projects showed a steady increase rising from an average of 17 in the previous strategy period to 25 in 2005 and 26 in 2006 (see Chart 2).

**Chart 1. Annual New Business (including regionals and TFPs)**



**Chart 2. Annual Number of Projects (excluding regionals and TFPs)**



The operating assets rose steadily from €570 million at the beginning of the review period to €737 million at the end of 2006. As a consequence of the addition of some large, slow disbursing infrastructure projects, the percentage of operating assets in the Bank's portfolio has fallen from 61% to 44% at the end of 2006. However, with the beginning of disbursements in 2006, it is expected that this trend will be reversed. Table 1 shows the net cumulative business volumes and total project values by sector and type of operation.

**Table 1 - Net cumulative business volume by Industry (as of 31 March 2007)**

Sector Business Group (SIC)	Sector Team (SIC)	Total Project Value	EBRD Finance	Private	Portfolio Ratio	% Share of Commitments
Energy	Natural Resources	221	92	92	100%	3%
	Power and Energy	275	198	0	0%	7%
<i>Sub-total Energy</i>		<b>496</b>	<b>290</b>	<b>92</b>	<b>32%</b>	<b>10%</b>
Financial Institutions	Bank Equity	58	36	36	100%	1%
	Bank Lending	480	400	400	100%	14%
	Equity Funds	326	120	120	100%	4%
	Non Bank Financial Institutions	16	13	13	100%	0%
	Small Business Finance	62	32	32	100%	1%
<i>Sub-total Financial Institutions</i>		<b>942</b>	<b>602</b>	<b>602</b>	<b>100%</b>	<b>21%</b>
General Industry	General Industry	1,059	473	451	95%	16%
<i>Sub-total General Industry</i>		<b>1,059</b>	<b>473</b>	<b>451</b>	<b>95%</b>	<b>16%</b>
Infrastructure	Municipal & Env Inf	63	41	0	0%	1%
	Transport	1,078	542	45	8%	19%
<i>Sub-total Infrastructure</i>		<b>1,141</b>	<b>583</b>	<b>45</b>	<b>8%</b>	<b>20%</b>
Specialised Industries	Agribusiness	1,426	727	727	100%	25%
	Property and Tourism	261	70	70	100%	2%
	Telecoms Informatics & Media	531	148	107	73%	5%
<i>Sub-total Specialised Industries</i>		<b>2,218</b>	<b>946</b>	<b>905</b>	<b>96%</b>	<b>33%</b>
<b>UKRAINE TOTAL</b>		<b>5,856</b>	<b>2,894</b>	<b>2,094</b>	<b>72%</b>	<b>100%</b>

1 The Bank allocates fractional counts to partially signed or partially cancelled stand alone operations.

## 1.2 Implementation of the Previous Country Strategy

### 1.2.1 Implementation of Main Strategic Objectives

In respect of **private sector development** the previous country strategy contained a focus on encouraging and sharing risk with foreign direct investors and investing in medium sized local manufacturing and agribusiness projects. This part of the strategy was fulfilled by the Bank's active participation in financing key foreign investors such as Mittal Steel Ukraine, but also cross-border transactions with sponsors from countries of operations such as the Polish companies Cersanit and Barlinek. A good example of investments in medium-sized companies was the loan provided to local pharmaceutical producer Farmak and the equity investment in Uksnab, a leading producer of cooling equipment. The strategic orientation to providing more equity and debt with longer maturities, and promoting syndications was fully implemented with the share of equity in the Bank's portfolio increasing by 25% during the review period and reaching 9.3% as at 30 April 2007. The share of syndicated debt also increased significantly during the review period (see section 1.2.3 below on mobilisation of commercial co-financing). The strategic goal of enhancing integrity and corporate governance in local private sector projects and supporting environment and energy efficiency related projects was pursued during the review period with the large loan for the "Ekoenergiya" cogeneration project at the Alchevsk Iron and Steel Works. This project will generate significant environmental benefits and energy savings and is the first project with a

large locally owned industrial group (the Industrial Union of Donbas) which is moving towards higher standards of corporate governance and transparency.

In the **financial sector** the Bank pursued its strategy to offer specialised credit lines for micro and SME finance, mortgage and energy efficiency. New banks such as Kreditprom were added to the group of financial institutions actively cooperating with the Bank. The strategic goal of supporting consolidation in the banking sector by providing new equity finance, particularly in the context of mergers of domestic banks or market entry by foreign strategic investors was implemented to a lesser extent due to the fast pace of entry of foreign banks.

The Ukraine Micro Lending Programme (UMLP, the “Programme”) expanded considerably in 2005 and 2006. Seven local partner banks are actively lending to micro and small enterprises (MSEs) through 719 branches/outlets in over 250 cities of 25 regions of Ukraine. Furthermore, an additional 190 mobile lending units are serving rural MSEs. As of end-2006, the Programme disbursed USD 2.4 billion in over 370,000 micro and small loans. The Programme has now disbursed over 13,000 MSE loans to around USD 100,000 each month. The Programme continues its strong focus in the micro sector, the historical average amount of loan disbursed is USD 6,520. The outstanding loan portfolio stood just under USD 1 billion as of end-2006 representing 139,000 micro and small loans. Over 83% of loans outstanding are loans for amounts below USD 10,000, further 14% are loans for amounts between USD 10,001 – 50,000. The quality of the MSE sub-loan portfolio remains excellent. Only 2% of the outstanding loans recorded arrears over 30 days, representing a portfolio at risk for over 30 days of 1.7%. The Programme has trained over 2,500 loan officers to date.

The rural and agricultural lending sub-programme was rolled-out in 2005 with the aim to reach out further to micro enterprises outside of cities and towns as well as farming communities. The rural lending programme disbursed over 27,000 loans amounting to USD 223 million. Currently, there are 69 specialised agricultural and rural lending units in UMLP partner banks, covering 51 cities and staffed by a total of 164 loan officers. The rural and agricultural lending now plays an important part of the MSE lending in the partner banks: for example in Kherson region, where agricultural lending pilot project started in Spring 2005 as a pilot project with a an important technical assistance support, rural lending accounts for 24% of the micro lending units, 28% of loan officers, 37% of the outstanding loan portfolio in terms of number of loans outstanding, and 23% of the volume.

The Bank will continued to promote private sector development of SME's through the Turnaround Management (TAM) and Business Advisory Services (BAS). Since its inception, TAM has provided 47 projects, utilizing EUR 3 million in funding from bilateral donors and the EU.

In the **energy and infrastructure sectors** the goal of supporting the restructuring and modernisation of Ukraine’s transport infrastructure was promoted through the financing of the main transport corridor linking Kiev to the EU border – the M06 highway. The largest section of that road was co financed with the EIB in 2006. During this period a second loan in support of Ukraine’s Railways became effective which will promote greater commercialisation and restructuring of the rail sector. The goal of promoting

new non-sovereign guaranteed structures was achieved in the municipal infrastructure with the first non-sovereign loan in favour of water utility of the city of Dnipropetrovs'k.

The safety upgrades of the K2 and R4 NPPs as well as the implementation of the Chernobyl Shelter project, despite delays caused by the need to properly review the tender process for the new safe confinement, have helped improve standards of nuclear safety.

The strategic goal of **developing local currency financing instruments** was pursued during the period with preparatory work being undertaken; however progress has been slow due to the difficult dialogue with the authorities. It is expected that activities will accelerate in the near future

## **1.2.2 Financial Performance**

As at 30 April 2007, the portfolio stands at EUR 1,745 million which represents a doubling of the portfolio during the review period. Operating assets have reached EUR 737 million with non-performing assets of only 0.3 per cent of operating assets; however, the overall portfolio risk rating of 5.72 is higher than Bank's average of 5.49. Cumulatively the mobilisation ratio (external finance/EBRD finance) was 2.0. The pace of disbursements improved over the last Strategy period, with average annual gross disbursements of EUR 270 million and 130 MEUR of average annual growth in net operating assets during the period. The level of cancellations of public sector projects has also decreased substantially and the percentage of operating assets has increased primarily reflecting improved co-ordination between the Bank and the Ukrainian Government through regular portfolio review meetings agreed under the multi-annual Program of Cooperation.

## **1.2.3 Mobilisation of Co-financing**

The level of commercial co-financing significantly increased to 100% of Bank financing in comparison with 22% in 2004. Cooperation with other IFIs, and donors has also been excellent, with EUR 16 million in donor funding in support of EBRD investments in the last three years with a focus on the financial, infrastructure and energy sectors. The significant increase in co-financing reflects the rising importance of Ukraine's corporates in the syndications markets. It is also due to the fact that EIB began its operations in Ukraine with a EUR 200 million co-financing of the M06 road together with the Bank. A further milestone was the first co-financing in Ukraine with JBIC for \$120 million in the context of the Ekoenergiya cogeneration project for the Alchevsk Steel Mill. The Bank was also leading co-financier in the financial institutions sector with the first medium-term syndicated loan for Kreditprom bank.

## **1.3 Transition Impact of the Bank's Portfolio and Lessons Learnt**

### **1.3.1 The Financial Sector**

**Banking** – The Bank's activities during the review period included a framework facility for selected banks for on-lending to private sector enterprises, a syndicated loan for the Kreditprombank and a mortgage credit line extension to Raiffeisenbank. Past integrity

issues and other negative governance factors however, prevented the Bank from entering into any new equity participation.

**SME & MSME** - Several credit lines and the Ukrainian Micro Lending Programme (UMLP) continue to have a significant impact. The UMLP has disbursed over US\$ 780 million in total and performs well in terms of portfolio quality, average loan amount and loan officer productivity. In addition and as a result, of the Bank's policy dialogue, the local authorities became generally supportive towards (M)SME.

**Private equity funds** – During the last strategy period the Bank has increased its commitment to the Euroventures fund and has made a new commitment to the SigmaBleyzer Southeast European Fund with a main focus on Ukraine. Generally, despite some increased PE activity, the environment has remained difficult, and substantial further reforms are necessary before a viable PE sector can develop. A **lesson learnt** from the engagement with Euroventures is to build a sufficient time horizon as severe delays can occur and an exit strategy via the local market is not quite realistic (PE04-260).

### 1.3.2 The Enterprise Sector

**Agribusiness** - A range of projects across the sector have restructured locally owned companies and promoted good corporate governance standards. However, the business environment is still considered very difficult and remaining challenges are large, with particular regard to land reform, mortgaging legislation and a functioning warehouse receipts system (WHR). A **lesson learnt** from the Bank's project with Gostomel Glass factory is that cautious phasing of investment helped the client to modernise and expand its operations and reduced the risks for the Bank (PEX05-271).

**Natural resources** - The Bank's presence in this sector was through two loans to Balkans Gas Transit and a loan to gasoline retailer Galnaftogas as well as the first equity investment in an exploration and production venture - Cadogan. These projects have achieved their objectives, e.g. to enhance financial transparency, to improve corporate performance and to improve gas transit, trade in products and introduce modern exploration technology. A **lesson learnt** from the Gastransit project is to align shareholders' interest by using a special purpose company with transparent contracts for i.e. gas compression and transportation services (PE04-269).

**Industry** – Bank investments include loans to Rubizhansky paper packaging plant and several steel, pharmaceutical and other manufacturing companies, enabling the modernisation of production processes and the realisation of efficiency gains. A **lesson learnt** for the Rubizhansky project is that the Bank can play a positive role in assisting defensive strategies developed by genuine investors in order to prevent speculative actions from other (undesired) agents (PEX05-271).

**Property and Tourism** - The Ukrainian property and tourism sector is featured by a difficult and non-transparent investment climate and the Bank was involved only in a few projects, such as Heitman Central Europe Property Partners Fund II, and the Orco Aparthotels projects in Kiev. For future activities, the property and tourism sector needs

further legal and regulatory reform, better governance on local level and increased exposure to international good practice.

### **1.3.3 Infrastructure**

**Power** - The Bank has extended a loan for modernisation and improvement of safety at the two nuclear reactors at Khmelnytsky (K2) and Rivne (R4), which has already had a strong impact on nuclear safety in the country. The Bank's Starobeshevo Loan has encountered significant delays in its implementation. A **lesson learnt** from this project is that delays in procurement and project implementation often lead to cost overruns and contractual disputes between the client and the contractor.

**Energy Efficiency** - The Bank has been active in the field of Energy Service Companies (ESCO), with engagements in private and public operators, and financed industrial projects with energy efficiency components. A **lesson learnt** from one of these projects, the steel mill ISTIL is that even small efficiency improvements can produce significant financial returns (PE03-232).

**Transport** - Two Railway development projects aimed to transform the state-owned railway company Ukrzaliznystia with commercialisation principles, such as corporatisation and separation of freight and passenger operations from infrastructure. In the road sector the Bank has been active through projects and policy dialogue. The Ukravtodor project for instance fosters improvements in road sector financing and financial management reporting. Finally, the Bank continued its support of the participation of foreign strategic investor (Austrian Airlines) in the airline business, enabling some skill transfers and achievements in corporate governance. Another two projects with Ukrrichflot (providing finance for the acquisition of new cargo vessels) have improved accounting and management standards.

## **1.4 Portfolio Ratio**

As of end of 2006 the portfolio ratio stood at 66% private vs. 34% public. The current project pipeline contains about 26% of public sector projects, which will leave the ratio within the same range.

## **1.5 Resident Office Activities**

Over the strategy period the Kiev RO has continued to play a leading role in project origination, policy dialogue with the Government on public sector projects, reforms and the establishment of a local currency lending program. The Resident Office maintains a close working relationship with Government institutions and other key stakeholders, such as public enterprises, clients, other IFIs and donor organizations. Over the strategy period, the number of sector team bankers permanently based in the Kiev RO rose to 7 including mobility moves from HQ, Warsaw, Moscow and Tashkent ROs resulting in a 25% increase in the total number of professionals based in Ukraine. A highlight of the review period was the approval by the Board of Directors of the opening of a second RO in Dnipropetrovs'k, which will support the expansion of the Bank's operations in the Eastern regions of the country. The opening of the office is scheduled to take place in October 2007.

## **2. OPERATIONAL ENVIRONMENT**

### **2.1 The General Reform Environment**

#### **2.1.1 Political Developments**

The political situation in Ukraine during the past two years has been unsettled. The first government appointed by President Yushchenko in early 2005, headed by then-Prime Minister Yuliya Timoshenko, lasted only until autumn of that year. Sharp disagreements between the President and Prime Minister, especially over the issues of re-privatisation and government intervention in the economy, caused a fatal split within the “Orange” coalition. Yuriy Yekhanurov, Timoshenko’s successor as Prime Minister, was a more moderate figure who sought to unite the country and re-build ties with Russia, and to get reforms on track. However, the prospect of parliamentary elections in March 2006 made it difficult to achieve policy consensus and kept the country in a state of political limbo. With electoral pressures mounting, the Yekhanurov government’s main achievement (aside from instilling a modest degree of political calm) was to conduct a fair and transparent re-sale of the Kryvorizhstal steel mill in October 2005.

The parliamentary election in March 2006 was free and fair according to international monitors, which is a major accomplishment for a post-Soviet country, where such assessments are rare. Media reporting on the election was open, the campaign was competitive and spirited, and the counting of the votes was transparent. The outcome of the vote, in which the Orange parties combined controlled a slim majority of seats, was similar to the outcome of the Presidential election in December 2004. The country remained divided, but the three Orange parties – Our Ukraine, Bloc Yuliya Timoshenko and the Socialist Party – garnered enough support to form a majority. Nevertheless, the leaders of these three parties – President Yushchenko, Mrs Timoshenko and Oleksandr Moroz – could not agree amongst themselves on how to allocate roles in a new government and coalition talks broke down. In its place, Viktor Yanukovich, head of the Regions party which collected the most votes of any single party in the election, cobbled together an ‘anti-crisis’ coalition made up of Regions, the Socialists and the Communist party. Although he wavered, President Yushchenko ultimately agreed to formally appoint Mr Yanukovich Prime Minister in July 2006.

Since that time, the President and Prime Minister coexisted in a state of uneasy alliance, occasionally veering towards intense rivalry. The difficulties stem from their competing interpretations of the Constitutional reforms that came into effect in 2006. President Yushchenko has sought to preserve his executive powers while the Prime Minister has been striving to further strengthen the authority of the Government. The Speaker of the Rada has also sought to limit the President’s authority through both legislative initiatives and a coordinated effort to build a veto-proof 300 seat majority in the Parliament. The struggle for power has been a major distraction that prevented the new Government from articulating and implementing a clear economic reform agenda. It also precipitated a government crisis in April 2007 when President Yushchenko signed a decree dissolving the Rada, which the Government and the leadership in the parliament challenged on legal grounds. As the Constitutional Court deliberated the

legality of the decree, the President and the Government started negotiations to reach a compromise and hold pre-term Parliamentary elections in September 2007.

## **2.1.2 Macroeconomic Conditions for Bank Operations**

Economic growth has been volatile over the past two years. After peaking at a record 12.1 per cent in 2004, on the back of high commodity prices and demand boosting social spending, real GDP growth collapsed to 2.6 per cent in 2005. In 2006, the economy rebounded to an estimated 7.1 per cent real growth, in spite of a 65 per cent hike in the price of imported natural gas from Russia.

On the supply side, growth in 2006 was broad-based; construction, retail trade, transport and communication were the fastest growing sectors of the economy. The international recovery of steel and other metal prices supported the rebound in industrial production and exports, as metallurgy and metal processing account for more than a quarter of total industrial production and about 40 per cent of total exports. A boom in private consumption, fuelled by generous increases in wages and pensions, and a recovery in fixed capital investment led growth on the demand side.

The strong growth momentum is expected to continue in 2007. The economy recorded real GDP growth in excess of 7 per cent in the first half of the year. Domestic consumption and investment continue to be the main drivers of growth, on the back of a lending boom, budgetary increases in wages and pensions and only a partial pass-through of higher gas import prices to end-users.<sup>1</sup>

One of the most significant changes in Ukraine's macroeconomic fundamentals over the last two years has been the reversal in the trade and current account balances, which have turned from surplus to deficit in 2005 and 2006, respectively. Higher energy import prices, coupled with strong real income growth, have boosted import demand for consumption goods and capital equipment, which grew faster than export capacity. As a result of increasing trade deficits, the current account balance switched into a small deficit of 1.5 per cent of GDP by end-2006, from a surplus of 10.5 per cent in 2004.

Record net foreign direct investment (FDI) inflows have eased the financing of these external imbalances and contributed to a more than twofold increase in the level of foreign reserves, which recovered from a low of US\$ 9.3 billion in December 2004, in the aftermath of the Orange revolution, to US\$ 28.9 billion (or 5.5 months of merchandise imports) at the end of August 2007. The nominal exchange rate has been *de facto* fixed at 5.05 Hryvnia/US dollar since a 5 per cent nominal revaluation in April 2005. Ukraine's higher inflation compared to its main trading partners led to an appreciation of the real effective exchange rate, which is gradually eroding the country's external competitiveness.

Monetary policy has been guided by the National Bank of Ukraine (NBU) objective to preserve exchange rate stability in the face of increasing net capital inflows. Money growth has thus been largely driven by repeated interventions by the NBU in the foreign exchange market to avoid depreciations/appreciations of the domestic currency. Real interest rates have remained negative since 2004.

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<sup>1</sup> As of January 2007, Ukraine pays US\$ 130 per thousand cubic meters (tcm) of imported gas compared to US\$ 95 per tcm in 2006.

Financial intermediation is deepening, helped by the entry of major foreign players in the Ukrainian financial market. Foreign banks have been active in retail lending and have supported the on-going process of re-monetisation of the economy. Since December 2004, domestic credit over GDP increased by an estimated 15 percentage points, reaching 47 per cent of GDP in 2006. This is mostly credit to the private sector, which grew from 25 per cent of GDP in 2004 to 45 per cent of GDP in 2006. Bank lending continued to expand. As of December 2006, bank loans had increased in real terms by almost 53 per cent year-on-year (y-o-y) to 50 per cent of GDP, while real deposits had grown at a slower 25 per cent y-o-y and accounted for 37 per cent of the country's GDP. Consumers' loans and mortgages in foreign currency have been among the fastest growing categories, albeit from a low base.

Despite higher gas import prices, inflation continued to decelerate until mid-2006. Lower food prices, which accounted for about 65 per cent of the consumer price index (CPI) and a tighter budgetary execution largely explain this positive outcome.<sup>2</sup> However, the declining trend in consumer price inflation reversed in the last quarter of 2006 when the impact of energy and other tariffs' increases was partially transmitted to household consumers. Average inflation is forecast to remain in double digits in 2007. The increasing divergence between the CPI and the producer price index (PPI) - 13.5 per cent versus 21.2 per cent growth in the year to July - is a sign of the underlying inflationary pressures in the economy which may intensify due to expectations of a poor harvest this year.

Fiscal policy was tightened in 2005 despite increased social spending. The consolidated general government deficit shrunk to an estimated 2.4 per cent of GDP from 4.4 per cent of GDP in 2004, when the outgoing Kuchma administration committed to overly generous increases in minimum wages, pensions and other social payments. The social re-distribution of budgetary resources continued in 2005, when pensions and wages were raised by an average of 50 per cent. The budget target was met thanks to a combination of higher tax revenues (in part due to the elimination of preferential tax treatments and special economic zones) and lower than budgeted public investment expenditure. The targeted deficit of 3 per cent of GDP in 2006 has been under-shot, due to higher than expected GDP growth and high VAT and personal income tax receipts. However, quasi-fiscal liabilities have increased<sup>3</sup>, especially in the energy sector where the financial position of Naftogaz Ukraine deteriorated markedly by year-end. The 2007 budget law targets a consolidated deficit of 2.7 per cent of GDP.

Total public debt remains low (around 17 per cent of GDP at the end-2006) and domestic debt is declining. The government preferred to use external sources to finance its fiscal deficits (See Section 2.3 below). Private external debt has been growing rapidly, albeit from a low base. Private short-term external debt reached US\$ 15 billion (14% of GDP) in 2006, higher than total public long-term debt (US\$ 14 billion or 13.2% of GDP). Banks accounted for about 42 per cent of total external private short-term debt in 2006 (or 6.1 per cent of GDP). Borrowing by other sectors is largely in the form of trade credits (48 per cent of total external private short-term debt or 6.8% of GDP).

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<sup>2</sup> A Russian ban on imports of meat and dairy products from Ukraine contributed to a fall in domestic prices on the Ukrainian market because of excess supply.

<sup>3</sup> The IMF estimates contingent liabilities at some 30 per cent of GDP (IMF – Article IV report, January 2007).

Although growth accelerated in 2006, short-term economic risks remain. Agriculture performance may experience a downturn because of a drought that is expected to have quite a negative impact on the grain harvest. On the external side, a protracted period of lower global liquidity and decreased appetite for risk, may have a negative impact on Ukraine growth in the medium term may cause a slowdown in private investment – an important support of economic growth last year – and lower private capital flows to Ukraine. Moreover, the economy is vulnerable to a terms-of-trade shock, which may be triggered by either swings in metals prices, Ukraine’s main export commodity, or sharp increases in energy import prices. In the short-term, energy price increases may push inflation up and have adverse effects on companies’ performance and, ultimately, on the state budget. In the long-term, the gradual convergence of domestic energy prices to international levels may act as a catalyst for the restructuring of the industrial sector and the implementation of energy efficiency measures.

The rapid growth in private external borrowing and bank lending in foreign currency, coupled with the high degree of “dollarisation” in the economy, are another source of economic vulnerability. As of December 2006, about 50 and 38 per cent of total bank loans and deposits were denominated in foreign currency, respectively, pointing at a growing imbalance in the currency composition of banks’ balance sheets. Improved banking supervision, greater exchange rate flexibility and the adoption of an inflation target could mitigate the risks that an external terms-of-trade shock is propagated to the domestic financial system.

It is however the lack of reform progress that is likely to act as the main constraint on the growth potential over the longer-term. Much will depend on whether the country can diversify the supply base and switch to an investment-led growth strategy from the current emphasis on consumption. Achieving this goal will require improving the business environment to attract further FDI, strengthening competition to improve efficiency, reducing the tax and regulatory burden and limiting the use of administrative controls. Significant investment will also be needed to overcome existing infrastructure and transport bottlenecks. Ukraine’s qualification to co-host with Poland the UEFA's 2012 European football championship may act as a catalyst for much needed investment in these areas.

### **2.1.3 Social and Labour Issues**

Ukrainians are one of the largest European ethnic groups and account for over three-quarters of the total population of the country. According to the latest official census, carried out in December 2001, the total population of Ukraine was 48.5 million, of which 32.6 million (67.2%) residing in urban locations and the remaining 15.9 million (32.8%) living in rural areas. The population has been on a declining trend since then, because of the relatively low fertility and high mortality rates, accentuated by the outward migration of workers. The largest Ukrainian community outside of Ukraine is in Russia, where an estimated 3 million Russian citizens consider themselves ethnic Ukrainians and have kept a close link with their motherland by fuelling a stable and growing inflow of remittances. Given that Ukraine is an aging society, these trends will reduce the workforce and increase the dependency ratio. According to ILO definitions,

the unemployment rate has declined over time and was estimated at around 7.5 per cent of the active population at the end of 2006<sup>4</sup>.

According to the latest World Bank estimates<sup>5</sup>, the share of the population living below the international poverty line of US\$ 2 per day, calculated at purchasing power parity (PPP), was about 5 per cent, mainly concentrated in rural areas and families with young children. The government has tried to reduce poverty mainly by increasing the minimum substance level to which both minimum wage and pensions are indexed. The process started in the run up to the presidential election in late 2004, when the incumbent government more than doubled the minimum monthly wage and pension. Since then, the minimum wage increased further from UAH 237 at the end of 2004 to an estimated UAH 400 by end-2006.

On most other social indicators Ukraine scores well with relatively high literacy rates and education enrolment ratios. However concerns remain over access to essential health care, especially for the poorest, and the rapid growth of tuberculosis and HIV/AIDS. Gender and ethnic discrimination remain a serious concern (See Annex 3). The government has adopted a programme to address these issues as part of the overall strategy to meet the 2015 Millennium development goals. However, it is unlikely that all its target will be met by the 2015 deadline.

#### **2.1.4 Legal Reform**

Over the period of the last Strategy there has been some relevant new legislation – most notably in relation to secured transactions. The first Ukrainian securitisation of mortgage loan receivables took place in early 2007 and further securitisations of other assets are expected during the next Strategy period. However, there remain important gaps and inconsistencies in the commercial law sector. In particular, the new Joint Stock Company law has not been approved yet; protection of minority shareholders remains a problem and many changes such as provisions on the issue of convertible shares and compulsory acquisitions of shares (squeeze-out provisions) which would significantly improve the legal regime for financial investors have not yet been passed into law. In addition, no progress has been made with respect to reforming insolvency law (which still ranks as one of the least compliant with international standards in the EBRD's countries of operations), and there has been limited progress in reforming the judiciary and related institutions which remain relatively poor when compared with other EBRD countries of operations. As a result, the development of capital markets is constrained and the phenomenon of so called “corporate raids” or illegal hostile takeovers using loopholes in legislation and weak judiciary is persisting in Ukraine.

#### **2.1.5 Environmental Issues**

Environmental challenges in Ukraine remain significant and present one of the most complex areas for the country to preserve its achievements and safeguard against the risk of further environmental degradation under the pressures of rapid economic growth and social transition. In spite of achieving considerable progress in addressing the

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<sup>4</sup> Official data report a lower unemployment rate of about 3 per cent.

<sup>5</sup> World Development Indicators (2006).

environmental legacy from the past, Ukraine's environment still remains in a critical state. There is an urgent need to integrate environmental considerations and improve energy efficiency in industrial, energy and agricultural sectors. Among burning issues of the country, especially in rural areas, are quality and access to safe drinking water, deterioration of municipal infrastructure and lack of sanitation facilities. Institutional capacity to ensure proper integration of environmental sustainability into mainstream decision-making needs substantial strengthening. Also the quality of urban environment needs improvement and key concerns relating to forestry and biodiversity conservation need addressing.

Studies by international organisations, such as the OECD Environmental Performance Review (Second Review, 2006), identified critical areas and challenges related to the country's management of the environment, namely: i) Improvements in environmental policymaking, planning and implementation, including introduction of IPPC BAT, use of Kyoto mechanisms, harmonization with the European Union *acquis communautaire* and better monitoring; ii) Mobilising financial resources for the environment by developing clear economic instruments as incentives for environmental protection, simplifying the system of environment-related taxes and pollution charges, as well as streamlining and prioritising expenditure from environmental funds; iii) Integration of environmental concerns into key economic sectors (industry, transport, energy and agriculture) and promotion of sustainable development, by reducing energy intensity and introducing clean technologies in industry, increasing energy efficiency in all sectors, developing renewable energy sources and advancing sustainable management of rural and urban land.

The environment is a key area for co-operation between Ukraine and the EU as strategic partners. Ukraine aims to align its environmental management approaches with the European Union's legislative and institutional practices, primarily through harmonisation of the national environmental policy in accordance with the Action Plan adopted in the framework of the European Neighbourhood Policy. The environment part of the Action Plan contains three main sections: environmental governance, prevention of deterioration of the environment (sector-specific legislation and programmes) and co-operation on environmental issues.

Further strategic directions of the country's sustainable development are set out in the 2003-2015 Comprehensive Program on National Implementation of the Decisions of the World Summit on Sustainable Development (Johannesburg, 2002) approved by the National Commission on Sustainable Development under the Cabinet of Ministers in Ukraine. Corresponding implementation sub-Programs include those on the Ecological Rehabilitation of the Dnipro River Basin and Enhancement of Drinking Water Quality; Protection and Rehabilitation of the Azov Sea and the Black Sea Environment (by 2010), On Ratification of the Kyoto Protocol to the United Nations Framework Convention on Climate Change (2003); on establishment of national environmental framework to halt the loss of biodiversity (by 2010) and National Program "Forest of Ukraine" (by 2015). Environmental considerations have also been introduced into the sectoral development programs such as the National Energy Programme till 2030, which calls for further reduction of the air emissions, waste water discharges and waste generation from the power sector through introduction of the energy efficiency measures; National Programme for Water Resource Use (2002), which provides for maintenance and protection of the rivers and for implementation of the economic instruments for water resource conservation. It will also be essential to build up

administrative capacity and implement regional cooperation activities that can have a transboundary environmental impact, such as water management in relation to the Danube Black Sea (DABLAS) Taskforce and the EU Water Initiative.

The decision by Ukraine to ratify the Kyoto Protocol in 2004 was an important step forward and has been followed by close cooperation between the EU and international financial institutions with the Ukrainian authorities on implementation of Kyoto agreements. This provides Ukraine with the means to monetise the environmental benefits of reducing greenhouse gases (GHGs) and to reduce harmful emissions and energy waste, and here the country will need to further build its administrative capacity and improve regional cooperation.

Ukraine is a member of United Nations Economic Commission for Europe (“UNECE”) since 1947 and has ratified the following UNECE environmental conventions:

- Convention on Long-Range Transboundary Air Pollution, 1980
- Convention on EIA in a Transboundary Context (Espoo Convention), 1999
- Convention on Protection and Use of Transboundary Watercourses and International Lakes, 1999
- Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters (Aarhus Convention) 1999.

Ukraine has not ratified the UNECE Convention on Transboundary Effects of Industrial Accidents.

Ukraine is party to some 26 international conventions and has approximately 70 multilateral and bilateral environmental agreements. The main remaining challenge is to that ensure domestic legislation to implement these commitments is enforced and financial mechanisms are in place.

In particular, Ukraine needs to prepare and approve action plans for implementing the "Environment for Europe" decisions (Kiev, 2003) in preparation for the Sixth Ministerial Conference of UNECE countries (Belgrade, 2007).

The Bank's environmental approach to Ukraine continues to reflect and address the country's environmental challenges and opportunities through the Bank's project portfolio and cooperation with other IFIs and regional initiatives (see Annex 4).

## **2.2 Progress in Transition and the Economy's Response**

Ukraine has made some progress in transition over the last Strategy period but major reform challenges still lie ahead. While market liberalisation, or first phase reforms,<sup>6</sup> has reached an advanced stage, second phase institutional reforms, like large-scale privatisation, governance and enterprise restructuring, competition policy, financial sector development and infrastructure, are far from complete.<sup>7</sup>

Internationally, Ukraine has made good progress towards WTO membership in the past two years, with the signing of bilateral accession protocols with the United States and Australia in March and May 2006, respectively. In November 2006 and June 2007, the parliament adopted the remaining WTO-related bills needed to join the organisation, including laws regulating banking and insurance services, veterinary standards, export duties on agricultural products, iron, steel and scrap metals. Completion of the WTO accession process, would pave the way for the start of negotiations with the EU on a Free Trade Area that could give a boost to the metals and chemical industry, as well as export-oriented Ukrainian manufacturers, by opening up European export markets.

Domestically, public administration reform and the fight against corruption were key reform priorities of the first post-Orange Revolution government led by Yuliya Tymoshenko. According to official sources, about 18,000 civil servants in the public administration were dismissed and the customs administration reformed. Amendments to the 2005 budget law changed significantly the tax regime and the social security system for entrepreneurs. They reduced the type of activities eligible for value added tax (VAT) exemption and eliminated tax holidays and preferential tax treatment in special economic zones (SEZs) and priority development territories. Although these measures helped to close tax loopholes and create a level playing field for entrepreneurs, their single-stage introduction helped raise the level of uncertainty over the regulatory framework and deterred new investment, which decelerated sharply in the first half of 2005.

The government led by Yuriy Yekhanurov restored confidence in the business environment, by taking a less interventionist stance on the economy and scaling back the focus on re-privatisation. However, there is still some way to go before a stable and transparent tax and business regulatory framework is in place in Ukraine. The country ranked 128<sup>th</sup> out of 175 countries in the World Bank *Doing Business 2007* report and tax administration and the regulatory burden remain among the top three obstacles to doing business in Ukraine, according to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey.

Net privatisation receipts peaked at US\$ 4.1 billion in 2005, mainly due to the resale of Kryvorizhstal, Ukraine's largest steel mill, to Mittal Steel for UAH 24.2 billion (US\$ 4.8 billion) in October 2005. This transaction, which was conducted through an open and televised auction, set the standards and raised the bar for future large-scale privatisations in the country. However, with the exception of Kryvorizhstal, no other large-scale enterprise was privatised in 2005. Privatisation revenues in 2006 fell short of the government target of UAH 2.1 billion (US\$ 416 million). The 2007 Budget Law revives the privatisation process by setting an even higher privatisation target of UAH

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<sup>6</sup> These are commonly defined as small-scale liberalisation, price liberalisation and trade and foreign exchange liberalisation.

<sup>7</sup> See EBRD Transition Report 2006.

10 billion (US\$ 2 billion), which could be realistically achieved only if the government were to privatise some of its large-scale strategic assets such as the fixed-line telecommunications monopoly, Ukrtelecom, or the Odessa port-side plant.

Despite slow progress in the privatisation of the incumbent fixed-line operator, telecommunications is one infrastructure area where there has been substantial progress in the last two years. Increased market entry stimulated higher competition in the provision of mobile telecommunication services, those penetration rate topped 100 per cent in December 2006. These developments, together with capacity improvements in the sector regulator, warranted an upgrade in Ukraine's EBRD infrastructure transition score in 2006.

In the energy sector, the government approved in March 2006 a new National Energy Strategy for Ukraine to 2030, which focuses on improving the country's energy security, strengthening its position as a key European transit country, promoting greater integration with the European electricity grid system and reducing the energy intensity in the economy, which is one of the highest in the EBRD region. The strategy also calls for an increase in the use of coal in power generation, the growth in nuclear power and the development of renewable and alternative fuels sources. Although the stated objectives reflect the government top priorities in the energy sector, especially after the two-day halt in gas supplies from Russia in January 2006, the Strategy falls short on concrete measures that would help achieve these goals.

In the banking sector, foreign participation increased significantly since the acquisition of Aval Bank, the second largest Ukrainian bank, by Raiffeisen International in 2005. The purchase was completed by end-October for an estimated price of US\$ 1 billion. Following that sale, BNP Paribas acquired a 51 per cent stake in UkrSibbank, the fourth largest Ukrainian bank by size of assets. Foreign investors have acquired a number of other smaller Ukrainian banks, bringing the share of foreign capital in the Ukrainian banking sector to about 30 per cent by end-2006.

The process of financial deepening went hand in hand with improvements in banking legislation, regulation and supervision. In particular, in April 2005 the NBU took steps to further liberalise the currency regime by abolishing the mandatory sale of 50 per cent of export proceeds. Also, in November 2006, the Ukrainian Parliament approved a bill on Banks and Banking – part of the package of WTO-related legislation – which allows foreign banks to open branches in Ukraine. This measure could stimulate competition and increase efficiency in the banking system. To strengthen the regulatory framework, the NBU increased minimum capital requirements, differentiated reserve requirements by currency and increased provisioning requirements for unhedged borrowers to discourage borrowing in foreign currency. Nonetheless, information disclosure, transparency over ownership and opaque lending practices in smaller banks remain a concern. The planned increase in the minimum capital adequacy ratio from 10 to 12 per cent would help the process of consolidation of Ukraine's financial system which still counts more than 160 different banks.

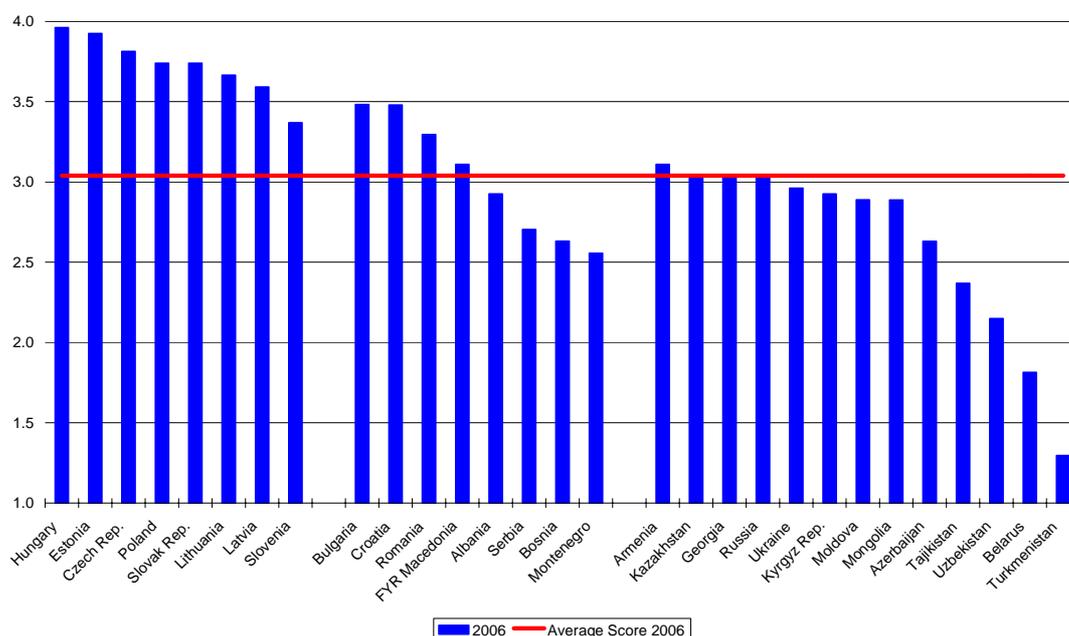
The non-bank financial system remains underdeveloped. The Law on Securities and the Stock Exchange, adopted in February 2006, sets the foundations for the much needed development of a securities market in Ukraine, by extending the range of regulated financial services, setting information disclosure requirements and strengthening requirements on statutory capital of non-banking financial institutions. However, weak

enforcement of property rights, the absence of a joint stock company law and lack of progress in pension and health care reforms remain major obstacles to the development of the non-banking financial sector in Ukraine.

Despite these achievements, Ukraine still faces major transition challenges. More needs to be done to bring the level of transition closer to that of a market economy. Although economic growth outperformed expectations in 2006, the estimated level of GDP growth had reached only 63 per cent of the level recorded in 1989, a measure of the still untapped growth potential of the economy.

An indication of the scale of the challenges ahead is apparent from Chart 3, which presents the 2006 average transition score across the EBRD region, with countries grouped by three broad regions: central Eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States and Mongolia (CISM).

**Chart 3: Average Transition Score**



Source: EBRD Transition Report 2006

The key transition challenges facing Ukraine are to:

- **Diversify the production base and improve the country's competitiveness**, in response to increased pressures coming from external suppliers, as the country is expected to join WTO in the near future and start negotiations on an extended

free trade agreement with the EU shortly thereafter. Achieving these goals will require further economic diversification (metallurgy and metal processing account for more than a quarter of total industrial production and about 40 per cent of total exports) and market liberalisation, limiting the use of administrative controls in the economy. To fully reap the benefits of greater trade and economic integration with the world economy, significant investment will also be needed to overcome infrastructure and transport bottlenecks.

- **Improve access to capital by developing local capital markets**, to meet the increasing financing needs of the corporate sector. Ukraine's financial sector experienced profound changes over the past two years. While financial intermediation is deepening, helped by the entry of major foreign players into the banking system, information disclosure, transparency over ownership, and opaque lending practices in smaller banks remain a concern. The development of a domestic capital market is still at an early stage and is hampered by the poor protection of minority shareholders rights, and lack of appropriate legislation to regulate issuance and trading of derivatives. The existence of burdensome currency regulations on investment by foreigners, weak regulatory frameworks for mortgage, leasing and factoring services and delays in the implementation of pension and health care reforms are further obstacles to the development of non-banking financial institutions.
- **Press ahead with energy sector reform**, by reducing cross-subsidisation among different categories of consumers and ensuring cost-recovery tariffs to stimulate investment and promote energy efficiency measures, promoting private ownership or operation of energy assets and strengthening the independence of the National Electricity Regulatory Commission.
- **Strengthen corporate governance and transparency**, by improving company law, advancing judicial reform, reforming the public administration and creating a playing level field for all private investors. The resale of Kryvorizhstal, Ukraine's largest steel mill, to Mittal Steel in October 2005 raised the standards for future large-scale privatisations in the country. However, there is still some way to go before a stable and transparent tax and business regulatory framework is in place in Ukraine.

### 2.3 Access to Capital and Investment Requirements

Access to international capital has improved substantially over the last strategy cycle and domestic sources of capital have been complemented by record net FDI inflows and bond issuance by both Ukraine sovereign and private corporates. So far this year, the country's domestic financial market has proven to be relatively insensitive to the financial turmoil in the Western markets. Macroeconomic fundamentals are strong and liquidity in the banking system remains high. However, spreads on sovereign and corporate bonds have widened substantially with respect to the record lows reached in April 2007. If protracted, this may affect Ukraine's medium-term growth prospects, as companies may find it more difficult to finance their future expansion plans. Bank

lending, which has been increasingly funded through external borrowing, may also slow down.

Over the past two years, the Ukrainian government has been an active player in the international capital markets. The major international rating agencies upgraded Ukraine's foreign currency sovereign rating in the aftermath of the Orange Revolution. The country is currently rated "BB-" by Standard & Poor's (with negative outlook) and Fitch (on positive outlook), while Moody's rates the country "B1". Following these upgrades, the Ministry of Finance successfully placed in October 2005 a 10-year maturity Eurobond of €600 million, at an annual yield of 4.95 per cent. In 2006, it raised a total of US\$ 1.6 billion in Eurobonds. In September, the government launched its first Eurobond denominated in Swiss francs (re-opened in November), for an amount equivalent to US\$ 307 million, with a 12-year maturity and a 3.5 per cent semi-annual coupon. In November, the Ministry of Finance placed a US\$ 1 billion 10-year Eurobond with a spread of 197 basis points over the US Treasury curve and a yield of 6.58 per cent. The Government placed a US\$ 500 million, 5-year Eurobond with a yield of 6.4 per cent in June 2007.

Domestic banks and large corporates have also stepped up their foreign currency issuance during 2005 and 2006, rising over US\$ 6.2 billion in the international capital markets. Similarly, access to the international loan market has also improved. In 2005-06, Ukrainian banks and companies raised a total of US\$ 3.8 billion in short-term syndicated finance, of which US\$ 1.2 billion and US\$ 0.9 billion by the banking sector in 2006 and H1 2007 alone.

Net foreign direct investment peaked at US\$ 7.7 billion in 2005, largely due to the re-sale of Kryvorizhstal and the sale of Aval Bank to Raiffeisen International. Although net FDI inflows continue to be sustained, at an estimated US\$ 5.3 billion in 2006 and US\$ 2.7 billion in H1 2007 (excluding the acquisition by Unicredit of a 95% stake in Ukrsofsbank for US\$ 2.2 billion, which is expected to be finalised in H2 2007), the overall FDI stock (almost US\$ 20 billion) remains well below the level recorded in similar-sized countries in Central and South-Eastern Europe, such as Poland (US\$ 80 billion) or Romania (US\$ 32 billion). Ukraine has the potential to substantially increase the amount of FDI it attracts, given proximity to the new borders of the European Union, the availability of a relatively cheap and skilled labour force and a number of large-scale companies still to be privatised. Whether this potential will be achieved, it will depend on further improvements in the business environment, the strengthening of property rights and an open and transparent privatisation process.

### **3. STRATEGIC ORIENTATIONS**

#### **3.1 Bank's Priorities for the Strategy Period**

For the forthcoming Strategy period, the Bank will seek to assist Ukraine in meeting the key transition challenges facing Ukraine as described in Section 2.2 by:

- promoting higher efficiency, competitiveness and diversification of the economy
- improving corporate governance standards in the local private sector and assisting foreign direct investment;
- promoting the further development of the capital markets and providing continued support to micro, small and medium-sized private enterprises through dedicated long-term credit lines with partner banks.
- promoting energy efficiency and security, environmental protection and sustainable use of natural resources throughout all sectors of the economy;
- improving efficiency and reliability of key transport infrastructure, power generation, transmission and distribution, municipal infrastructure and of the oil and gas transport systems of Ukraine.

In order to address the sectoral challenges it will be facing in the coming years in Ukraine, the Bank will need to offer additional products and develop new approaches both in the public and private sectors by using its experience from more advanced transition economies. In particular, the Bank will actively consider financing on a non-sovereign basis those public sector enterprises in the transport, power, telecommunications and natural resources sectors, which have achieved significant progress in corporatisation, restructuring and transparency.

Within its local currency program, the Bank will seek to offer Hryvnia financing in the municipal sector, in the mortgage and consumer finance market and to enterprises with unhedged exposure to local currency fluctuation.

A key element in providing financing to large infrastructure projects with a trans-European dimension will be the co-operation and co-financing of such projects with the EIB within the framework of the agreements reached between EIB and EBRD for the CIS region. The Bank will also seek to attract and utilise grant co-financing from EU and other donors to complement projects in the infrastructure, municipal, energy efficiency and renewable energy sectors as well as for coal mine safety projects. (See Section 4 for a more detailed description of cooperation with EIB.)

In the private sector the Bank will seek to increase further the share of equity in its portfolio and to continue to expand the horizons of syndicated lending both in terms of amounts and maturity and by introducing Ukrainian borrowers to more participants in the syndication markets. The Bank will also seek to support the diversification of Ukraine's economy by identifying bankable projects in the automotive, aerospace, media and telecommunications areas.

What the Bank can achieve under the proposed Strategy is contingent on the progress in reforms in the coming years. It is hoped that the Government of Ukraine, in addition to

its ambitious public infrastructure investment program, will develop strong intention for reform in the corporate, capital markets, tax and justice areas.

The Bank will enhance its regional focus by opening of a second Resident Office in Dnipropetrovs'k, which will support the expansion of the Bank's operations in the Eastern regions of the country. In the light of experience with the operation of this office further regional expansion in the Westerns and/or Southern regions of Ukraine will be considered during the Strategy period.

## **3.2 Sectoral Challenges and Bank Objectives**

### **3.2.1 Corporate Sector**

The Bank will continue to provide financing to both local and foreign corporates. The main focus in manufacturing will be to support **local companies** in their drive for better energy efficiency, modernisation and introduction of international environmental standards. This will include financing some large local companies which have made demonstrable progress in improved transparency and corporate governance with special emphasis on projects with significant energy efficiency and environmental benefits in the metallurgy, chemical, machine building and automotive sectors.

The Bank will also support the increasing flow of **foreign direct investment** which is expected in such areas as: agribusiness, consumer goods, metallurgy, capital goods, construction materials, property and oil and gas. As many European companies have started to shift gradually their production facilities further east in search of lower costs of doing business, Ukraine will continue to be a good location due to its proximity to the EU market as well as its skilled labour force.

Of particular interest will be the support of inward **cross-border investments** by corporates from the Bank's countries of operations neighbouring Ukraine such as Poland and Russia and investments by Ukrainian companies in that region.

### **3.2.2 Energy Efficiency**

#### **Transition goals**

Energy efficiency will be the key operational priority of the Bank for the next Strategy period. Ukraine is one of the most energy intensive countries in the world and has tremendous potential for energy efficiency - it is only one-third as energy efficient as the average EU 15 country.<sup>8</sup>

Recent increases in Russian gas prices and consistently high oil prices on world markets have led to gradual increases in tariffs and have created stronger incentives to energy users to address efficiency, particularly in the industrial sector. This represents an important opportunity for the Bank to have a significant impact on transition through implementing energy efficiency projects with high demonstration effect.

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<sup>8</sup> For a more detailed review of the Bank's energy efficiency strategy, see Annex 5.

Energy efficiency offers a powerful tool for achieving the Bank's transition goals in Ukraine. First of all, improved energy efficiency would cut fuel costs, thereby increasing competitiveness for businesses and directly enhancing welfare for Ukrainian consumers (especially in the context of energy price increases). Secondly, lower demand for energy would reduce energy security concerns by reducing Ukraine's dependence on imported fuels. Thirdly, energy efficiency generates environmental benefits and stimulates new services and jobs.

Efficient energy use has substantial implications for Ukraine's national security. Ukraine is highly dependent on energy imports for the majority of its total primary energy supply. As the majority of primary energy comes from the Russian Federation, Ukraine is vulnerable to political fortunes in its neighbouring country. Reducing energy consumption through more efficient energy use would definitely help break this dependence.

Energy efficiency is also essential for economic growth and improved living standards in Ukraine. Direct and indirect subsidies, which are aimed at maintaining the consumer's ability to pay for energy, devastate municipal budgets and erode the quality of public services.

The Bank's transition goal will be to continue its energy efficiency initiatives in all sectors of the economy: both through direct lending in the corporate sector and through an expansion of intermediated lending within the framework of energy efficiency credit lines. This will entail not only providing the financial resources but also the technical expertise to identify and implement a wide range of energy efficiency investments, particularly in the industrial sector.

### **Operational focus**

The main operational focus in energy efficiency will be the following:

- Enlarging investments in energy efficiency across industrial sectors:
  - the Bank will encourage all its clients to assess energy efficiency opportunities as part of any project with the Bank. TC resources will be made available for energy audits and energy management trainings;
  - the Bank will actively market energy efficiency opportunities to attract new clients for whom energy saving is a part of corporate strategy;
- Providing implementation support to energy efficiency projects – in particular energy management training – to ensure investments do take place and facilitate the transfer of skills to enhance the sustainability of activities;
- Financing small and medium energy efficiency and renewable energy projects via local banks with dedicated credit lines – Ukrainian Energy Efficiency Programme for Banks (EUR 100 million);
- Working with institutions in the financial sector to develop and implement mechanisms to finance energy efficiency in the residential sector, including use of technical assistance and grant co-financing;
- Accelerating policy dialogue in the area of energy efficiency; providing support to the National Agency for Efficient Use of Energy Resources and the Parliamentary Committee for Fuel and Energy Complex, which are developing

energy efficiency and renewable energy legislation, in particular on small hydro and “green energy tariffs”;

- Enhancing dialogue with donors by participating in the Donor Government Working Group on Energy Savings and Renewables;
- Facilitating the purchase of carbon credits from clients in the framework of the Netherlands EBRD Carbon Fund and the Multilateral Carbon Credit Fund. The Bank will work with the Ministry for Fuel and Energy and the Ministry of Environmental Protection to develop institutional capacity for approving the sale of carbon credits and will assist clients, particularly in the power and municipal infrastructure sectors, to identify and prepare carbon credit transactions.

### **3.2.3 Power and Energy**

Ukraine has opportunity to become a major player supporting the energy needs of Europe. Ukraine’s own requirements are also vast. With one of the highest levels of energy intensity in the Bank’s region, Ukraine needs investment in all areas of the sector to improve efficiency and security of supply. The Bank [will help support the implementation of the MoU on EU-Ukraine cooperation in the field of energy \(of 1 December 2005\) which is the cornerstone of EU-Ukraine cooperation on energy.](#) Without major investment, which will eventually require private sector involvement, Ukraine faces a scenario of shortages in the medium term.

#### **Transition goals**

- finalize the liberalization process, including tariff reform, to attract investments;
- further develop the Wholesale Electricity Market Concept legislation to allow bilateral contracting;
- strengthen the independence of the regulator;
- restructuring the excessive levels of debt in the sector left over from past periods; and
- join UCTE and the Energy Community Treaty, and promote convergence by Ukraine with EU regulations in the energy sector, catalyzing important reforms as well as allowing Ukraine to trade more energy with Western neighbours.

#### **Operational focus**

The key areas of operational focus will be to:

- encourage the government to restart the privatisation process and stand ready to provide pre and post privatization finance to companies in the sector.
- until privatisation is restarted, finance upgrades to distribution in state-owned companies, in order to improve efficiency and quality and security of supply as well as corporate governance. Where state entities are financially solvent, provide financing on a non-sovereign basis, to reward sound financial practices and achieve a strong demonstration effect;

- the Bank will promote renewable projects as an alternative to fossil-based projects and will engage in policy dialogue and consider TC funding to help introduce renewable related tariff structures to support such projects;
- support private sector involvement in power distribution as well as generation, focusing on projects aimed at the improvement of efficiency in conversion, and distribution of energy, the quality of energy services and corporate governance;
- promote international standards of nuclear safety in Ukraine; and
- engage in a policy dialogue with the government and coordinate with other donors and IFIs to promote the necessary structural and regulatory reforms consistent with the transition goals outlined above.

### **CSF and NSA**

In July 2007 meetings of the Chernobyl Shelter Fund (CSF) and the Nuclear Safety Account (NSA) Assemblies reaffirmed their commitment to further assist Ukraine in completing the Shelter Implementation Plan (SIP) projects, notably the New Safe Confinement, and the NSA funded spent fuel storage and liquid waste treatment facilities. The two Assemblies also approved respective Grant Agreements. Additional funding will certainly be required not later than 2009 and the Bank, as the Funds' manager, will be engaged in supporting the pledging initiatives led by G8 and the EU.

Under the CSF most of the SIP tasks have been completed and the detailed design and construction of the New Safe Confinement, a project in the range of €500 million is planned to start in summer of 2007. Stabilisation of the existing Chernobyl Shelter, successfully completed in 2007, has substantially reduced the risk of its collapse for 10 to 15 years. Way before then, the Shelter will be enclosed in the New Safe Confinement and the deconstruction of the most unstable parts will have begun.

The work on the two NSA financed facilities has resumed in August 2007 after the NSA Assembly approved the way forward for the completion of these two facilities essential for safety and decommissioning of Chernobyl nuclear power plant shut down in 2000.

Successful implementation of these very large and complex technical projects will require professional excellence by the contractors, the Client and its Project Management Units. It will also require close co-operation with the Ukrainian regulatory and administrative authorities. The Bank, together with its Ukrainian counterparts, will have a major role in ensuring that these conditions are put in place and maintained until the completion scheduled for 2011.

### **3.2.4 Natural Resources: Oil, Gas and Mining**

Ukraine is a net importer of oil and gas supplying only 18% of current consumption from domestic sources. Ukraine is well endowed with coal deposits, up to 6.5 trillion tonnes by some estimates with proven deposits of 117 billion tonnes, but the sector remains substantial unreconstructed. Ukraine's principal role in natural resources is for oil and gas transit to Europe from Russia and the Caspian region. This major resource artery however is based on the maintenance of, in many instances, 30-40 year old pipe, weak and energy inefficient compressor stations, inadequate storage facilities, and poor control and metering functions due to old and inefficient metering equipment and the

lack of metering capabilities at the main entry and exit points of the territory of Ukraine. Ukraine has also one of the largest coal reserves in the world, however also one of the worst mine safety records in a sector which needs significant investment in mine safety and improvement in regulation. Recent developments in the coal industry of Ukraine, such as the emergence of profitable private sector producers and adoption of a government strategy for the sector which includes the privatisation of several viable mines, opens an opportunity to support the transition process in the coal sector.

### **Transition goals**

- Reconstruction and modernisation of the transit infrastructure to ensure energy security, promote energy efficiency, and to provide better metering control for transparency and governance;
- Improving governance and the transparency of the NAK Naftogas Ukraine system and promote its commercialisation;
- foster private sector investment through more open government policy and increased regulatory transparency;
- increase the use of domestic oil, gas and clean coal technologies e.g. modern coal to gas technology and cleaner power plant conversion.

### **Operational focus**

The key areas of medium term operational focus will be:

- the modernisation and development of the transit infrastructure including pipe, compressor and metering stations and storage. This includes the infrastructure development and modernisation facilities being discussed with Ukrtransnafta and Ukrtransgas in the context of the implementation of the MoU on energy signed between the EU and Ukraine, the tripartite EC/EIB/EBRD MoU of December 2006 and the bilateral MoU with the EIB;
- engagement of NAK structures besides oil and gas transit such as in oil and gas exploration and development;
- finance private sector investments and FDI in the sector to support domestic producers and service providers committed to transparency and high Health & Safety standards and attract wider outside participation in domestic production and energy efficiency. This will include support of private infrastructure developers, and support (including possible EBRD equity participation) in suitable resource developers such as Cadogan; and
- helping finance the development and expansion of quality retail providers of fuels including alternative fuels such as LPG and CNG. This will include in the near term continued support of Galnaftogaz as well as other equally qualified retailers, and assistance in developing opportunities in alternative fuel distribution such as the CNG and LPG retailers.
- finding suitable partners in the coal sector, focussing on mine safety, energy efficiency and climate change issues.

### **3.2.5 Transport**

The Bank will continue to play a crucial role in developing the transport infrastructure of Ukraine, and will take appropriate account of the recommendations of the High-Level Group on the extension of the main trans-European transport axes to neighbouring countries as well as of the Long-Term TRACECA Strategy.

A key strategic change will be the gradual move to non-sovereign financing in the transport sector: e.g. for Ukrainian Railways, the air navigation authority and possibly the Ukraine Postal Service.

The preparations for the finals of the European Football Championship in 2012 are expected to become a powerful catalyst for investment by public and private sources in order to upgrade Ukraine's transport infrastructure in a sustainable fashion to meet the requirements of this event.

#### **Transition goals**

- Complete the process of corporatisation of UZ and continue reforms in the railway sector including enhanced access of private operators.
- adopting modern road concessions legislation enabling investments in the road sector through PPP schemes
- development of sectoral strategies for Ukraine's regional airports and maritime and river ports in order to remove bottlenecks, increase efficiency of passenger and freight operations, improve air navigation safety and help realise more fully the transit potential of Ukraine in line with the recommendations of the Baku working groups, the TRACECA long-term strategies and the recommendations of the High Level Group.
- starting negotiations on a Common Aviation Area with the aim to fully integrate Ukraine into the EU single aviation market and into European aviation structures. Ukraine will take over the EU aviation legislation and the relevant standards for example in the field of safety or air traffic management.

#### **Operational focus**

The key areas of medium term operational focus will be:

- completing modernisation of the M06 road linking Kiev to the border with the EU as well as financing the implementation of other major international axes;
- continuing the policy dialogue with the Ministry of Transport to assist the Government in adopting modern road concessions legislation and road sector PPP schemes. This will be complemented by a possible pilot project for a road concession tendered under the new legislation;
- supporting the corporatisation of the Ukrainian Railways and investment in rolling stock, traffic control automation and energy savings, development of main international axes;
- encouraging the necessary modernisation process in the Ukrainian aviation sector, and improving the safety of air operations, the necessary infrastructure and by consolidating the airline industry.

### **3.2.6 Municipal and Environmental Infrastructure**

A new Budget Code adopted in 2001 provided for a package of municipal finance reforms and enabled Ukrainian cities to borrow without the need for sovereign guarantees. Following this, some larger Ukrainian cities were able to access both local and international financial markets and raised small amounts of financing with short maturities. However, municipal finance needs are still largely unmet.

#### **Transition goals**

The Bank's fundamental transition goal in this sector is to improve the creditworthiness and to enable municipalities and municipal utility companies to access long-term financing for rehabilitation of municipal services. This implies:

- Greater transparency and accountability;
- Improved, operational management and long term planning skills;
- Adequate tariff structure for municipal services providing for full cost recovery and no cross-subsidies within the affordability constraints;
- Improved efficiency in provision of municipal services, especially energy efficiency;
- Improvement of legal framework for municipal finance including laws regulating borrowing, security, execution and also legal and financial relationship between central government and municipalities; and
- Greater private sector participation based on the Bank's guidelines for procurement of concessions.

#### **Operational focus**

During the strategy period the Bank will aim to:

- provide financing to municipalities and, where applicable, regional utilities without a sovereign guarantee, in order to support decentralisation of financing responsibilities and contribute to the enhancement of the creditworthiness of municipal borrowers;
- work closely with utilities to support transparent Public Private Partnership arrangements, where possible;
- consider sovereign or sovereign guaranteed financing for municipalities of a smaller size;
- develop intermediated financing schemes involving local banks for smaller municipalities and smaller municipal companies;
- provide local currency financing to municipalities and municipal utilities, in order to match the currency of their cash flows better, when local currency financing becomes feasible;
- consider structuring of municipal housing projects based on recently developed approach for the Russian market in Surgut;
- consider financing sustainable municipal transport and other infrastructure in the context of the preparations for the finals of the European Football Championship in 2012 to meet the requirements of this event.

Affordability constraints will remain an issue and the Bank will calibrate investment sizes, structures and tenors to ensure long term affordability. The Bank will seek sources of grant investment finance from donors where affordability constraints limit the loan funded investments below the levels needed to achieve efficient technical and environmental solutions. The Bank will continue to incorporate the use of TC funds to ensure that institutional capacity building is achieved and the project achieves sustainable results. Institutional assistance will be aimed both at utility companies and local municipalities to address corporate governance, financial, operational and commercial capabilities.

### **3.2.7 Financial Sector and Micro, Small and Medium Enterprise Finance**

#### **3.2.7.1 Financial Sector**

##### **Transition goals**

- support the development of domestic capital markets;
- encourage foreign investment in the banking sector as a means of strengthening the capital base of local banks as well as increasing competition;
- support consolidation and strengthening of the capital base of locally owned banks sufficiently to enable them to meet the expected continuing strong growth in demand for credit;
- Strengthen regulation and supervision of the banking and financial services sectors; and
- Promote the development of mortgage lending; leasing and pension funds.

##### **Operational focus**

- support the growth and institutional development of locally-owned banks by investing in their capital and providing long-term funding to the banking system in the form of subordinated loans, syndicated loans, SME credit lines or energy efficiency lines.
- seek new medium to small size partner banks especially in the regions.
- engage in policy dialogue over the strategy for the two state-owned banking institutions (Ukreximbank, Savings Bank).
- develop local currency financing instruments based on the approach used already in Russia and other countries;
- participate in securitization transactions to support the further growth of financial institutions; and
- participate actively in the emergence of a health insurance, leasing, pension funds and consumer finance sectors.

#### **3.2.7.2 Micro, Small and Medium Enterprise Finance**

### **Transition goals**

- improve the access of creditworthy MSEs/SMEs to sources of reliable finance ;
- foster competition among the MSE lenders in the country;
- further development of efficient and easily accessible financial products to MSEs, especially in rural areas and the agriculture sector; and
- improve the training and management capacity for MSE lending operations, including areas such as internal audit and MIS.

### **Operational focus**

- Support existing partner banks which are already funding more than 50% of the MSE loan portfolio out of own funds, to keep pace with the growing demand for micro and small loans in Ukraine.
- Expand the overall operations into the previously under-served regions.
- Continue to expand the rural and agricultural lending in order to reach out further to the smallest communities and therefore smallest of MSEs
- Continue to put special emphasis on the gender issues. Currently approximately 50% of MSE borrowers are women;
- set up another 50 - 100 MSE cities could be reached in 2007/2008.
- Further loan officer and banks staff training. Around 700 loan officers are envisaged to be trained in 2007-2010.
- Increase the availability of MSE lending and increase competition in the sector and thereby quality of services provided to MSE borrowers by attracting new partner banks and other MSE finance providers to join UMLP, particularly regional based institutions.
- Concentrate on increasing lending efficiency through setting up in-house training capacities as well as enhancing lending technologies.

The Bank will continue to promote private sector development of SME's through the Turnaround Management (TAM) and Business Advisory Services (BAS) Programmes, designed to assist the development and growth of SMEs in the Bank's countries of operation. Areas of particular focus are management skills, market positioning, information systems, quality certifications, technical and environmental upgrades. BAS has yet to establish an office in Ukraine, but a Feasibility Study has been completed in 2006. This study concluded that there is enterprise need for the type of assistance offered by the BAS Programme, justifying the BAS Team to pursue supporting MSMEs in Ukraine, and to help build the local business consultancy sector specialising in MSMEs. It will be a priority for the Bank to assist TAM/BAS to mobilise funding for maintaining TAM operations and establishing 1-3 BAS Offices in Ukraine. Funding from EBRD's net income may become available to fund these new BAS offices, while financing and/or co-financing from various donors, including the EU, will also be sought to further support BAS operations.

### **3.2.8 Agribusiness**

#### **Transition goals**

The Bank's key transition goals for the sector are to:

- complete the development of a fully functioning warehouse receipts (WHR) system through technical assistance (facilitating the implementation of the secondary legislation related to out-of-court settlement procedures and a creation of an indemnity fund and the overall finalisation of the system) and support market-based mechanisms for the regulation of grain trading;
- modernise agricultural processing with a special focus on industries with significant linkages to other sub-sectors (such as raw material supply, primary processing, agri-based renewable energies and packaging);
- support the development of logistics and distribution (including warehousing, distribution centres, wholesale and retail distribution for foodstuffs); and
- support the modernisation and development of locally owned companies in the agribusiness sector.

#### **Operational focus**

In pursuit of these goals, the main areas of operational focus will be to:

- encourage greater Foreign Direct Investment whether through financing investments alongside foreign strategic investors or by helping the development of locally owned corporates in sectors that may attract foreign investment in due course.
- increase efforts to work with strong local companies;
- increase lending to local and foreign-owned players against pledges of agricultural commodities and warehouse receipts (enhanced where appropriate by pledge of other assets). This can take the form of financing via or with the aid of local commercial banks using the warehouse receipt system when available or other transitional structures;
- focus on financing industries with downstream linkages in the food chain – the distribution and retailing of food and fast moving consumer goods; and
- maintain focus on financing the introduction and development of strong local brands and innovative products, product quality improvements.

### **3.2.9 Property and Tourism**

#### **Transition goals**

Key transition goals in the Property and Tourism sector include:

- Increase the number of international standard hotels, particularly in Kyiv and other major cities and resorts;
- Privatise and upgrade state-owned hotels;
- Support the development of tourism-related projects;
- Promote the development of logistics and warehouse infrastructure and increase the supply of institutional grade office and modern format retail premises in Kyiv and other major cities.
- Support mixed-use development projects involving combinations of the above property types.

### **Operational focus**

In the property and tourism sector the Bank will seek to support both international and local developers and investors through a variety of financing instruments, including senior debt, mezzanine debt, direct equity and equity funds.

In terms of sub-sectors, the Bank will continue to support investment in office; retail; logistics; hotel; residential and mixed-use developments in Kiev and in Ukraine's regional cities.

In addition to supporting environmentally sustainable projects, some of which might contribute to urban regeneration, the Bank will seek to contribute to the development of the local construction and building materials sectors and promote the transfer of technology, knowledge and management skills to Ukraine's property and tourism markets.

The Bank's specific operational priorities in the property and tourism sector will include:

- in the hotel industry the Bank will play a role in meeting unfulfilled demand by continuing to support projects that introduce international standard hotel management and service levels. The Bank will pursue quality international city centre hotel opportunities, including mid range hotel developments in Kyiv, in order to promote better infrastructure and address growing demand from international business travellers. The Bank will also identify opportunities to support hotel chains in major Ukrainian regional cities.
- The Bank will selectively support the privatisation of city (Odessa, Lviv) and resort (Crimea) hotels;
- The Bank may promote credit lines for smaller tourism projects as part of its effort to encourage SME development.
- The warehousing and logistics market will remain an important sub-sector for the coming years. There is a significant potential for development, as most of the existing warehousing stock is inadequate for modern logistics management and proper storage.

- The evolution of local retailing is expected to contribute to growth in warehouse demand and development.
- The Bank will selectively support projects that promote better office and retail infrastructure in response to proven demand. Factors constraining the development of suitable office and retail space include vague and inconsistent planning regulations and legal framework uncertainty, lack of transparency and scarcity of investment capital.

The Bank will also consider supporting **mixed-use** developments, including possible combinations of office, hotel, retail, logistics and residential project elements.

### **3.2.10 Telecommunications**

#### **Transition goals**

The key transition goals in the telecommunications sector are to:

- ensure an effective privatization and liberalization of the telecoms sector, this requires the establishment of an international standard legal/regulatory framework including a timetable for full liberalisation of the telecoms sector, tariff rebalancing, and a fully functioning independent regulator;
- attract private investment for modernisation and expansion of the sector, particularly fixed line, which is characterized by low levels of penetration and digitalisation including low broadband access and limited data transmission products.
- liberalise the sector to attract competition and supporting investment in the alternative telecom sector;
- support the further development of the Ukrainian mobile market, including funding of UMTS 3G at the incumbent and various mobile operators; and
- support the development of alternative technologies of Wimax, cable, television and a diverse and vibrant media sector.

#### **Operational focus**

The key areas of medium term operational focus for the Bank in telecommunications will be:

- Subject to decisions about the timing, size and mode of Ukrtelecom's privatization, the Bank might play a role in the Ukrtelecom privatisation through financing its acquisition and/or taking an equity stake;
- enhance the volume and tenor of financing to accelerate network development if needed, as well as support alternative domestic and international operators competing in this market;
- Building on its experience in various countries in CEE and the CIS, the Bank will continue to examine opportunities to invest in alternative service providers (i.e. WiMax), television, including free to air, cable and satellite, as well as other media

including radio, cinema, publishing, media distribution, outdoor advertising ventures and software developers and IT service companies.

#### **4. OTHER IFIS AND MULTILATERAL DONORS**

The Bank continues to co-operate closely with the other IFIs which are active in Ukraine, partly to ensure consistency in approach towards the Ukraine authorities in areas of mutual interest, for example reform of the energy sector and development of the financial sector, and also to ensure that programmes are complementary and do not overlap. Bank staff participates regularly in donor coordination meetings with all major IFIs and donor organisations in Ukraine. Bank staff meet other IFIs in Kyiv, at donor forums and working groups initiated by the Bank or by the World Bank, or at meetings of the Energy Sector Task Force or similar bodies.

There is frequent contact with the World Bank on financial sector activities, especially mortgage-lending and regulation of non bank financial institutions and other areas where the Bank's selective institution-building orientation complements the World Bank's more systemic approach. There is significant complementarity between several of the IFC's stand alone TA programmes, such as those relating to Corporate Governance and Leasing, and concrete investments by the Bank. With respect to the IMF the EBRD has maintained regular contact with the staff both in Washington and Kyiv.

##### **4.1 World Bank**

Since Ukraine joined the International Bank for Reconstruction and Development (World Bank) in 1992, the World Bank has committed over \$4.8 billion for 40 operations in Ukraine, including IBRD commitments of \$4.7 billion for 34 operations, \$120 million for one guarantee facility, \$32 million for four Global Environment Facility (GEF) grants, and \$5.5 million for one Carbon Offset project. The largest sectors to which commitments have been made include Energy and Mining, Public Administration, and Finance.

The World Bank's current portfolio in Ukraine amounts to \$1.1 billion in net IBRD commitments with 12 active loans. In the public sector, projects include State Tax Service Modernization and Development of the State Statistics System for Monitoring Social and Economic Transformation; in energy and infrastructure, Kiev District Heating, Hydropower Rehabilitation, and Lviv Water and Wastewater projects; in finance, the Second Export Development and Access to Financial Services projects; in agriculture, Rural Land Titling and Cadastre Development project; and in the social sectors, Social Investment Fund, Social Assistance System Modernization, TB and HIV/AIDS Control, and Equal Access to Quality Education projects. The current pipeline of projects includes an additional 10 operations planned for approval by the World Bank Board of Directors in fiscal years 2007-08.

## 4.2 European Investment Bank

Current operations of the EIB in Ukraine are governed by the Decision of the Council of the EU dated December 2004 (2005/48/EC), concerning EIB operations in Russia, Ukraine, Belarus and Moldova, and from the subsequent confirmation from the EU Commission to the EIB to start operations in Ukraine dated May 2005. EIB became operational in Ukraine following the ratification by the Ukrainian Parliament (Rada) of the EIB-Ukraine Framework Agreement in February 2006. The overall ceiling for the afore-mentioned countries is EUR 500 m. The Mandate expires on 31 July 2007. Eligible projects shall be in the sectors of (1) environment, and (2) transport, telecommunications and energy infrastructure on priority TEN axes having cross-border implications for an EU Member State. The EIB lending activity shall also satisfy the criterion of cooperation and, where appropriate, co-financing with other international financial institutions ensuring reasonable risk sharing and appropriate project conditionality.

The new 2007-2013 Mandate of the EIB stems from the Decision of the Council of the EU dated December 2006 (2006/1016/EC), which covers EIB operations in, *inter alia*, Eastern Europe (Ukraine, Moldova, Belarus\*), Russia and Southern Caucasus (Georgia, Armenia, Azerbaijan). The Council Decision outlines the scope of the new Mandate for the Bank in Russia, Eastern Europe and Southern Caucasus as follows:

*“As regards Eastern Europe, Southern Caucasus and Russia, the EIB should enhance its activities in the countries concerned in line with appropriate conditionality consistent with EU high level agreements with the country in question on political and macro-economic aspects. In this region, the EIB should finance projects of significant interest to the EU in transport, energy, telecommunications and environmental infrastructure. Priority should be given to projects on extended major Trans European Network axes, projects with cross-border implications for one or more Member States and major projects favouring regional integration through increased connectivity. (In the environmental sector, the EIB should in Russia ...). In the energy sector, strategic energy supply and energy transport projects are of particular importance. EIB Financing Operations in this region should be carried out in close cooperation with the European Bank for Reconstruction and Development (‘the EBRD’), in particular according to the terms {to be} set out in a tripartite Memorandum of Understanding {MoU} between the Commission, the EIB and the EBRD {signed on 15 December 2006}.”*

The overall ceiling for EIB credits to Eastern Europe, Southern Caucasus and Russia is EUR 3.7 bn. The Mandate expires on 31 December 2013.

### Current pipeline in Ukraine

- European Roads Ukraine - M-06 Highway (signed)

The project involves the rehabilitation of the M-06 highway between Brody and Kiev and was signed on 27 July 2007. The loan amount is of up to EUR 200 m. The project is co-financed by the EBRD (which has already signed its EUR 200 m loan in December 2006).

- Ukrenergo Power Transmission (appraisal stage)

The project involves the construction of a power transmission connection in Ukraine. The loan would be guaranteed by Ukraine. The envisaged loan amount for the EIB is up to EUR 150 m. The project will be co-financed by EBRD with the same loan amount. Signing is expected in the second half of 2007.

EIB and EBRD are jointly evaluating further projects in the energy sector (Ukrtransnafta and Naftogas) and possibly in the telecom sector (Kyivstar and UMC/MTS).

### **Future activity**

Future activities over the coming 3-year period 2007-09 in the sectors covered by EIB's new Mandate will, as new projects become gradually identified, be carried out jointly with EBRD under the aegis of the MoU. EIB and EBRD teams are – and will continue – closely coordinating their efforts in this respect, including common missions, project structuring and term sheets, etc.

Given the size of Ukraine and its importance in the Eastern Neighbours region, significant projects can be expected notably in energy and transport, provided however that the political climate is stabilised and overall transparency (in particular in the energy sector) improved.

### **4.3 European Union**

The major areas of co-operation between the EU and the EBRD include environment, energy and SME finance support. EC assistance includes major contributions to funds managed by the EBRD, namely the Chernobyl Shelter Fund (€240 million) and the Nuclear Safety Account (about €21 million so far). In addition, Euratom and the EBRD granted a \$125 million loan (\$83 million and \$42 million respectively) for the safety upgrading and modernization of the two nuclear power stations at Khmelnytsky and Rivne (K2/R4 project) after their start-up.

A Partnership and Co-operation agreement (PCA) between the EU and Ukraine was signed in 1994 and entered into force in 1998 for an initial 10 year period. A number of specific agreements are also in place in the fields of trade, science and technology, and nuclear energy. Within that legal framework, present cooperation is largely based on the Joint EU-Ukraine Action Plan concluded in 2005. Negotiations on an ambitious new Enhanced Agreement which will replace the PCA were launched beginning March 2007. However, negotiations of a deep and comprehensive Free Trade Area, which is a key element of this agreement, will only start once Ukraine has completed its WTO accession process. The future FTA will have a strong focus on regulatory convergence in a number of key areas concerning bilateral trade.

During 2005 and 2006, the level of assistance provided to Ukraine through the TACIS National Programme was increased to €88 million in 2005 and €100 million in 2006. This assistance focussed focus particularly on implementation of the Joint EU-Ukraine

Action Plan, which was endorsed by the EU-Ukraine Co-operation Council in February 2005. From 2007, EU assistance to Ukraine is through the new European Neighbourhood and Partnership Instrument (ENPI). An indicative allocation of around €500m is proposed for 2007-2010, focussing on Support for Democratic Development and Good Governance, Support for Regulatory Reform and Administrative Capacity Building, and Support for Infrastructure Development.

EU funded ENPI Cross-Border Co-operation programs are being prepared between Ukraine and neighbouring countries to address common challenges such as economic and social development of the border areas, environment and communicable diseases, illegal immigration and trafficking, efficient border management and people-to-people contacts. These will build upon the Neighbourhood Programmes first developed under Tacis and Interreg or Phare from 2004.

The EC made major contributions to the improvements of nuclear safety in Ukraine. From 1991 to 2006 these amounted to some €420 million: in addition to the €240 million committed for the Chernobyl Shelter Fund, the EC allocated also €65 million for the additional costs of electricity production in order that Ukraine could close the last operational unit at Chernobyl in December 2000. The approved strategy under the Instrument for Nuclear Safety Cooperation provides for the continuation of nuclear safety cooperation/assistance to Ukraine in the period 2007-2013 at a substantial level.

To be noted is also the previously mentioned Tripartite Agreement (MoU) between the European Commission, in liaison the EIB and the EBRD, which organises the cooperation between the three participants in Eastern Europe, Southern Caucasus, Russia and Central Asia. The MoU establishes a preferred mutual partnership between the EIB and the EBRD, through which each bank offers the other a right of first refusal to co-finance projects in areas covered by the Council's decision on EIB's external mandate.

## ANNEX 1 POLITICAL ASSESSMENT

### ***Compliance with Article 1***

Ukraine is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank.

During the past two years Ukraine's democratic political transition has progressed. Political institutions have been strengthened and have placed the country on a course toward a European style representative democracy. Most importantly, the parliamentary election of March 2006 was deemed free and fair by international monitors and was characterised by a lively campaign and genuine political competition. Another positive development is the noticeable improvement in media freedom and civil society development. These are impressive achievements; however, democratic consolidation will take time and it is still necessary to convert the broad consensus in pro-European values into a workable programme of political and economic reform. At the top of the agenda is the need to clarify the respective powers of the President, the Cabinet and the Parliament, as contained in the amendments to the Constitution which went into effect in 2006. Ongoing disputes over the meaning and intent of these changes have resulted in political stalemate and a deterioration in policy effectiveness.

### ***Political Accountability***

Ukraine's political leaders are held accountable through periodic contested elections at the national level. The President is elected for a five-year term through a popular vote, and is limited to two consecutive terms. Parliamentary elections are held every five years according to a proportional representation voting system. Five parties or blocs crossed the 3 per cent threshold needed to form a faction in the March 2006 elections to the current Supreme Council (Rada), Ukraine's unicameral legislature.

Progress in the electoral process was evident in the final round of the Presidential election in December 2004 and the Parliamentary election in March 2006. The conduct of the repeat second round election between Viktor Yushchenko and Viktor Yanukovich was assessed positively by the independent Ukrainian Committee of Voters and the OSCE. Although some technical flaws were noted, there were improvements from previous rounds in the campaign conditions, the transparency of the voting and vote-counting procedures and the objectivity of media reporting according to OSCE monitors.

According to the OSCE/ODIHR final Election Observation Mission report, the Parliamentary election on 26 March 2006 was conducted "largely in line with OSCE commitments, Council of Europe commitments and other international standards for democratic elections". Independent observers noted minor problems with election administration – including overcrowded polling stations, inaccurate voter lists and unfamiliarity with counting procedures – but there was no evidence that the incumbent sought to interfere with the campaign, the voting or the counting. The OSCE/ODIHR report praised Ukraine for the "inclusive candidate registration process", the "vibrant media environment" and the overall "respect for civil and political rights" which enabled genuine voter choice and political competition.

Notwithstanding the consolidation of democratic progress reached through the improved conduct of national elections, there remain some significant weaknesses in accountability under the current Ukrainian political system. These stem primarily from the uncertainties that have arisen over the implementation of Constitutional reforms agreed in December 2004 and put into effect from January 2006.

The reforms shifted power from the executive to the parliament and, within the executive, from the President to the Prime Minister. The main changes brought about by the reforms can be summarised as follows:

- Immediately following Parliamentary elections, a coalition of parties/blocs that enter the Rada must create a majority that then proposes a candidate for the post of Prime Minister, and the Parliament then approves the composition of the Cabinet nominated by the Prime Minister. If the steps in this process are not completed within a prescribed period of time following the election, the President has the right to call new elections.
- The President has the right to nominate the Prime Minister and Ministers for Foreign Affairs and Defence, who are then approved by the Parliament.
- The entire Parliament is elected according to the proportional representation system with mandates allotted from party lists only (in place the previous mixed PR and single mandate district system) and deputies serve 5 year terms instead of 4.
- The authority to appoint the 18 judges on the Constitutional Court, which previously was dominated by the President, is shared equally among the President, the Parliament and the Congress of Judges.
- The Prosecutor General is responsible for monitoring the observance of rights and freedoms by the President and other organs of the executive branch, and reports to the Parliament.

In principle, these measures move Ukraine further toward a European model of parliamentary democracy and introduce necessary checks and balances into the system that had been absent under the 1996 Constitution. However, implementation has been hampered by some remaining inconsistencies and ambiguities, which result in part from the hurried circumstances under which they were adopted, and in part by a lack of political will.

The Constitutional reforms were reviewed by the Council of Europe's Venice Commission, which noted several areas where overlapping competencies among the President, the Parliament and the Government could become a source of future conflict. The Parliamentary majority aggravated the problem when it passed a new Law on the Cabinet of Ministers in early 2007 which sought to further undermine the powers of the Presidency. According to the Venice Commission, the Law was inconsistent with the Constitution, and, moreover, endangered the core democratic principle of separation of powers.

One of the key areas where the Constitutional reforms have been questioned by legal experts is in the insistence on the so-called "imperative mandate". This requires that only parliamentary factions may constitute a majority (not individual deputies) and prohibits individual deputies from joining factions other than the ones they belonged to

when they were elected. The Venice Commission noted that this would interfere with “the free and independent mandate of the deputies, who would not be in a position to follow their convictions”. The departure from the imperative mandate rule in practice was one of the triggers for a Presidential decree issued on 2 April 2007 dissolving the Rada and calling for new elections.

In sum, the basic building blocks of democratic accountability are in place in Ukraine: free and fair contested elections; political parties with identifiable constituencies and policy orientations; a legislature with adequate powers to check the executive; a vibrant, diverse and independent media; and a politically engaged population and active civil society organisations that operate freely. What is lacking at this stage of Ukraine’s democratic development is a clear and widely accepted set of Constitutional rules that will allow for stable and effective governance, especially as the country is still sharply divided along geographic, geopolitical and ideological lines.

### ***The Rule of Law***

The Orange Revolution at the end of 2004 marked a turning point in the application of the rule of law in Ukraine. Public outcry over the misconduct in the second round of the Presidential election and the mobilisation of wide-scale peaceful protest was matched with a formal legal challenge made through the courts. In the end, the Supreme Court of Ukraine reviewed the case and handed down an impartial judgement that provided a secure path out of the country’s political crisis. Regrettably, since that time the authorities in Ukraine have not done enough to strengthen the judicial system and reinforce the rule of law. Significant problems remain in the areas of judicial integrity and independence, consistency among laws, politicisation of rulings and enforcement. Inconsistent enforcement of property and contract rights, weak minority shareholder protection and widespread corruption are frequently mentioned by business managers as difficulties in the business environment.

Independence of the judiciary is guaranteed by the Constitution, but this is not always upheld in practice. Political interference in judicial rulings is believed to be common and both prosecutors and judges are often accused of taking bribes. The Constitutional Court, which has the final say on the constitutionality of legislation, presidential decrees and Cabinet acts, has been hobbled. First, the Court was unable to convene for much of 2005 and 2006 due to the absence of a quorum. The Parliament prevented hearings on 14 nominations for Court appointments submitted by the Presidential administration and the Congress of Judges. Then, when a quorum was established in August 2006, the Constitutional Court’s purview was scaled back by adoption of legislation prohibiting the Court from deciding on the constitutionality of the Constitutional amendments made in December 2004. Legal scholars have questioned the constitutionality of this law. Finally, the Constitutional Court should have been the ultimate arbiter of the legality of President Yushchenko’s decree dissolving the Parliament in April 2007, but its integrity was put under question by accusations of political pressure and corruption. Three Constitutional Court judges were dismissed in the midst of the hearings.

The role of Procuracy has also come under scrutiny. The Constitutional reforms enacted in 2006 granted new powers to the General Prosecutor’s office. This aspect of the reforms dilutes the authority of the courts to oversee the conduct of the executive branch and shifts it to the Procuracy, which answers to the Parliament. The Venice

Commission wrote in its assessment that “the extension of the power of the prosecutor can be considered a step backward not in line with the traditions of the Procuracy in a state of law”.

An independent assessment of the judiciary in Ukraine by the American Bar Association’s Central European and Eurasian Law Initiative (ABA/CEELI) published in December 2005 noted serious problems with judicial corruption and susceptibility to political interference, a low level of public confidence in the judiciary and weak enforcement of judicial decisions, lack of objectivity in the appointment and oversight of judges, inadequate funding of courts and court officials, overwhelming caseloads and deficiencies in judicial training. These myriad problems have contributed to difficulties in the business environment for domestic and foreign firms operating in Ukraine. In particular, the problem of “raidering” has become widespread in the country. Hostile takeovers of firms, especially small and medium sized enterprises, leave both minority and majority shareholders vulnerable. The courts have not proven a reliable defender of property rights in these cases due to accusations of judicial corruption.

Bearing these difficulties in mind, judicial reform has become a top priority of the Presidential administration. In May 2006, the National commission to strengthen democracy and the rule of law in Ukraine adopted a Concept on the improvement of the judiciary in line with European standards. The reform blueprint includes steps to address the selection of judges, to prevent corruption during trial proceedings, to increase compensation of court officials and to improve disciplinary procedures for judges. However, a lack of political consensus and periodic instability has prevented much of the blueprint from being implemented.

Both high level and administrative corruption persist in the public and private sectors in Ukraine. Improvements in overall transparency, civic engagement and media freedom are a check on the spread of corruption, but also draw attention to illicit conduct that might have gone underreported in previous years. According to Transparency International’s Corruption Perception Index, Ukraine has a score of 2.8 out of 10 (where 10 is least corrupt), indicating rampant corruption.

The close association between business and politics in Ukraine, still a strong feature of the political system even after the Orange Revolution, contributes to the problem of high level corruption or “state capture”. The potential for corruption is especially evident in the reappearance of VAT arrears, in the effort to bring back special economic zones, and in the Government’s administrative interventions in the economy (for example in the introduction of licenses and quotas in the grain export market in 2007). Selective enforcement of tax laws are also an expression of high level corruption. Ukraine still does not have adequate conflict of interest legislation, and enforcement of its laws on asset declaration of top officials is weak, which feeds these problems.

While elections have become cleaner, political corruption has nevertheless become more prominent, as evidenced in President Yushchenko’s claims that deputies from the opposition factions in Parliament were lured into an alliance with the governing coalition through corrupt transfers. “The root problem of the Ukraine system of power”, Yushchenko stated in a speech in April 2007, “is political corruption”.

The authorities freely acknowledge the pervasiveness of corruption and have been working with various international partners and bilateral donors on steps to address the problem. The European Union's assistance strategy for Ukraine, under the European Neighbourhood and Partnership Instrument, has placed a high priority on supporting good governance, rule of law reform, regulatory reform and building administrative capacity. Similarly, the United States' Millennium Challenge Corporation under a two-year threshold programme is working to assist Ukraine in many of the same areas. Ukraine cooperates with the OECD's Anti-Corruption Network Istanbul initiative on developing an anti-corruption action plan, and also joined the Council of Europe's Group of States against Corruption (GRECO) in 2006. The Council of Europe is currently implementing a "Project against corruption in Ukraine" which runs until June 2009.

### ***Civil and Human Rights***

The Constitution guarantees protection of all basic rights and freedoms, and these are generally respected in practice. Assessments of civil and human rights conditions in Ukraine by monitors from the Council of Europe, the European Commission, the US State Department, and numerous domestic and international NGOs suggest a marked improvement in the past two years. Journalists, NGOs and individual citizens can publicly criticise the authorities without fear of reprisal; the media is more diverse and has greater access to government and court proceedings; there is unrestricted access to the Internet; political demonstrations occur unimpeded by government interference; and there has been progress in the enforcement of minority rights.

Advocacy groups and human rights monitors continue to raise concerns about treatment of women and the problem of trafficking. Discrimination in hiring and sexual harassment in the workplace are common problems, despite efforts by the authorities to improve legislation ensuring gender equality. Violence against women, especially spousal abuse, is illegal but also quite common according to local NGOs. According to the 2006 Trafficking in Persons report issued by the US State Department, Ukraine is a tier 2 country, suggesting that more remains to be done to address the problem. The report states "the Government of Ukraine does not fully comply with minimum standards for the elimination of trafficking; however, it is making significant efforts to do so". There have been improvements in law enforcement capacity in the past two years: the Government has strengthened the anti trafficking provisions in the criminal code and the authorities have made investigation of trafficking a higher priority. However, most convicted traffickers still receive probation instead of prison sentences and corruption in the judiciary and police impedes the Government's ability to combat trafficking.

## ANNEX 2 LEGAL TRANSITION

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws “on the books” (also referred to as “extensiveness”) and the actual implementation of such laws (also referred to as “effectiveness”). All available results of these assessments can be found at [www.ebrd.com/law](http://www.ebrd.com/law). This annex presents a summary of the results for Ukraine, accompanied by critical comments of the Bank’s legal experts who have conducted the assessments.

### **Capital Markets**

On 23 February 2006, the Ukrainian Parliament approved a new Law on Securities and the Stock Market. This law entered into force on 12 May 2006, replacing the previous, 1991, law. The new law is the principal legislation on securities markets and represents a positive step towards the elimination of a number of gaps and contradictions between the Civil and Commercial Codes with respect to securities and the stock market.

The new law details regulation on issuing and trading securities and on professional brokers while lessening the distinction between open and closed joint stock companies: closed companies are now allowed to offer shares in open subscriptions (provided that the first subscription is limited to founders only). The new law revises the concept of a “preference share”, provides for different classes of preference share, sets out mechanisms for their conversion and increases the permitted percentage of preference shares from 10% to 25% of the authorised capital. The new law also introduces new regulations on listing and prospectus requirements, insider information and trading, and new rules governing the activity of stock exchanges in Ukraine. Since 12 May 2006 the basic law governing stock exchange activity has been the Civil Code, while the relevant provisions of the Commercial Code have been repealed and the contradictions in the definitions and purpose of a stock exchange set out in different laws eliminated.

The State Commission on Securities and the Stock Market is the Ukrainian market regulator. The Commission has authority to license and regulate market participants and to register securities issues, including the circulation of securities of foreign issuers in Ukraine. The Commission is financed by the state budget and is an Ordinary Member of IOSCO.

### **Company Law and Corporate Governance**

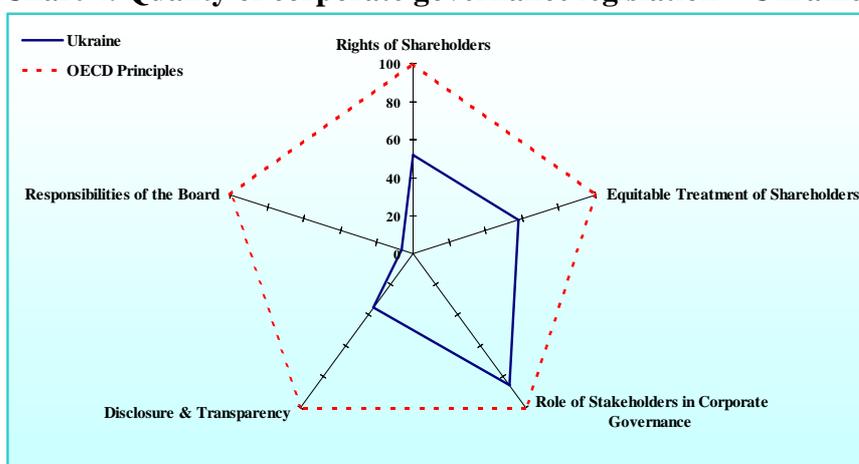
The primary sources of law relating to corporate governance in Ukraine are the Law on Enterprises in Ukraine and the Law on Business Associations. On 1 January 2004, a new Civil Code and a new Commercial Code entered into force, substantially amending the existing legal framework. While these codes improved the existing legal framework they also appear to have created several problems relating to interpretation and application: new provisions conflict with each other and a complicated interpretation

exercise needs to be performed in order to understand which provision prevails in a specific scenario.

A first important step in resolving this issue was taken with the enactment of the new Law on Securities and the Stock Market. A further step which is still outstanding is the need to prepare a draft Joint Stock Companies Law and submit it to the Verkhovna Rada (Ukrainian Parliament) for consideration.

When most recently assessed by the EBRD, in 2004, Ukrainian corporate governance legislation was measured as being in “very low compliance” with the OECD principles (see Chart 4 below). In particular, disclosure rules concerning company information were found inadequate, the duties of a company’s board of directors unclear and the provisions concerning shareholders rights insufficient.

**Chart 4. Quality of corporate governance legislation – Ukraine (2004)**



*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the ‘web’, the more closely the corporate governance laws of the country approximate these principles

Source: EBRD Corporate Governance Sector Assessment, 2004 assessment

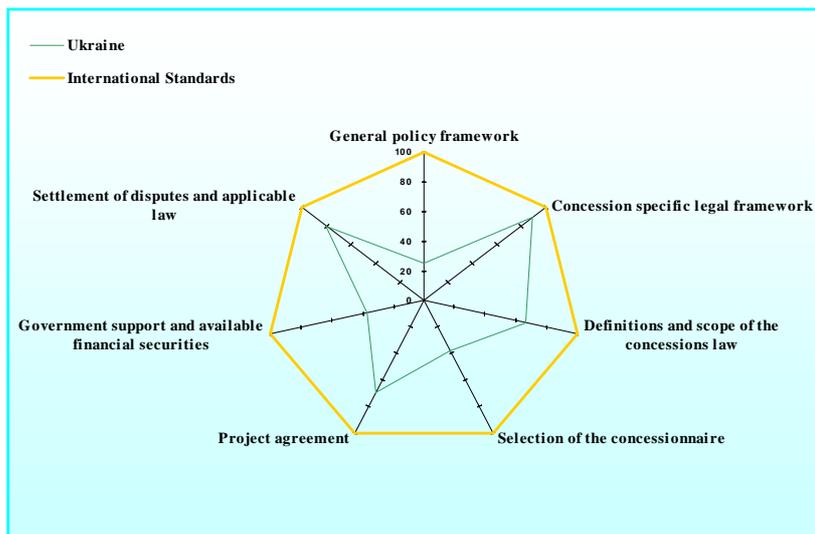
In June 2003 a Corporate Governance Code titled “Ukrainian Corporate Governance Principles” was enacted. These principles are intended for open joint stock companies traded on the stock market and are voluntary.

In 2005, the EBRD conducted a survey for testing the effectiveness of corporate governance (how the law works in practice). A case study dealing with related-party transactions was designed. The survey revealed that a minority shareholder - owning more than 10% shareholding - has, by virtue of law, access to different avenues to seek disclosure from the company (i.e. he can request an independent audit or call a shareholder meeting to ask information to the management). Unfortunately, all actions are deemed quite complex and lengthy as it is quite easy for the defendant to delay the proceedings. The difficult enforcement and the weak institutional environment add to the complexity of the actions. Company books are considered generally reliable but the framework on related party transaction is weak. Competence and experience of prosecutors and market regulator need to be improved while corruption and partiality of judgements are still reported as major problems.

## Concessions

The Ukrainian Law “On Concessions” of 1999 (the “Concessions Law”) serves as a general framework law for concessions. In addition, rules regulating concessions are found in the Economic Code of Ukraine of 2003, as well as in some sector specific acts (for example in motorway sector). The Concessions Law provides terms and procedures for the concession of state and communal property, including procedures for public tendering. Rules regulating project agreements provide relatively clear guidance on the main issues to be covered and remain sufficiently flexible to allow the parties to negotiate freely.

**Chart 5. Quality of concession legislation – Ukraine (2005)**



*Note:* the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the ‘web’, the more closely concessions laws of the country approximate these standards.

*Source:* EBRD Concessions Sector Assessment 2005

While the Concessions Law constitutes a relatively solid legal basis for the development of Private Sector Participation (PSP) in infrastructure and utilities sectors, certain improvements, however, would be desirable. In particular, the Concessions Law is somewhat uneven in that, while it clearly defines the scope of application, more detailed tender rules (i.e. incorporation of principles of transparency, non-discrimination, proportionality and efficiency, clear regulation of the pre-selection procedure and of review procedures) should be developed. Additionally, identification of, and collaboration between, different public entities involved in the process should be improved. There is further room for improvement in the Concessions Law relating to the lender’s position where security and step-in rights are concerned, as these remain unregulated.

The 2004/5 EBRD Concession Laws Assessment, undertaken to evaluate applicable regimes throughout the EBRD countries of operations, (the law on the books only, rather than how those laws work in practice), revealed that Ukrainian laws were in “medium compliance” with internationally accepted standards. As can be seen from the chart above, while general framework rules and rules such as those covering settlement of disputes in concession-related arrangements are regulated fairly extensively, most other areas (in particular, selection of a concessionaire, availability of financial instruments and state support) need further improvement to match the standards of a modern legal framework facilitating private sector participation. One further dimension that will inevitably require the attention of the authorities is policy framework, the

absence of which makes any law, even an ideal one, extremely difficult to implement. While a draft policy document has been produced by the Ministry of Economy, it may not be sufficiently robust to guide implementation of the relevant reforms. EBRD advisors have produced another draft policy document produced in the course of a motorway PPP technical cooperation project which may be a useful comparator for the Ministry in refining its policy document.

According to the 2006 Legal Indicator Survey evaluating the workability of concession regimes in practice, the Ukrainian regime was rated as having a medium level of effectiveness. Of particular concern was possible recovery of investment following termination of a concession agreement.

## **Insolvency**

This law is severely deficient in virtually all of key areas of insolvency. The restructuring process is of particular concern. While the law is notable for allowing the conversion of a bankruptcy to a restructuring and vice versa, the restructuring process is inadequately spelled out and the few provisions that are included provide no requirement for independent assessment of the plan of reorganisation, very little involvement of the general body of creditors and no supervision of the plan's implementation. Given these limitations it seems unlikely that an effective, efficient and transparent reorganisation could take place under this law. In addition, the law fails to provide for the timely delivery of property of the debtor to the bankruptcy administrator or for the effective avoidance of suspicious pre-bankruptcy transactions.

The above deficiencies could be classified as 'critical' or 'threshold' deficiencies in that they are imperative to the basic functioning of a proper insolvency law. In addition to these fundamental failings, the Insolvency Law has several other important shortcomings. In particular, the requirements for the commencement of bankruptcy proceedings are too complicated; there are inadequate requirements for the qualification of a bankruptcy administrator; there are no provisions for set-off; and, there are insufficient sanctions for failure to comply with the law.

Although the Insolvency Law does contain some positive elements, such as the requirement for a speedy hearing and determination of proceedings and the ability to do a pre-packaged restructuring utilising both a bankruptcy to extinguish debts and a reorganisation to restructure the company, it is unlikely that such provisions work well in practice.

The results of the EBRD 2004 Legal Indicator Survey, which measured the "effectiveness" (or how the laws work in practice) of insolvency regimes in the Bank's countries of operations, clearly show that the practical application of the Insolvency Law is likely to be expensive, fairly slow and unduly complex. All of these factors would militate against the speedy determination of proceedings provided for in the letter of the law. In addition, the results of the survey show that the predictability and competence of judges hearing bankruptcy cases is fairly unreliable.

## **Secured Transactions**

In the last couple of years Ukraine has undertaken considerable reform in the field of commercial law, particularly in relation to secured transactions. The adoption of new Civil and Commercial Codes, and specific laws related to security over movable property and immovable property (together with extensive work on the supporting institutions such as registers) has fundamentally changed the conditions under which commercial transactions take place. Despite some confusion and uncertainty (not unusual in transition economies), it appears that these changes have been, by and large, positive, particularly with respect to mortgage finance, which is on the increase.

Security rights over movable assets in Ukraine are, as of today, largely governed by the Law on Securing Creditor's Claims and Registration of Encumbrances (Securing Creditor's Claims Law), which entered into force on 1 January 2004. The Law on Pledge of 2 October 1992 (as amended) remains in force but is now of more limited relevance since it only applies for matters not covered by the Law on Securing Creditor's Claims (although which matters is unclear). The Civil Code of 18 January 2003 also includes relevant provisions in the chapter on security for the fulfilment of obligations. The Securing Creditor's Claims Law adopts an approach according to which all encumbrances (e.g. pledges, leases) are treated similarly and require registration in the State Register of Encumbrances over Movable Property for the right to be effective against third parties. Such register, which replaces the State Register of Pledges of Movable Property, started operation in August 2004 and all encumbrances entered into the latter prior to 1 January 2004 have been transferred to the new Register automatically.

The main weakness of the regime lies in its lack of flexibility in the description of the collateral and of the secured debt. Taking security over generally described assets, or fluctuating pools of assets, remains uncertain, despite fairly liberal provisions in the law and legal advisers are usually reluctant to utilise such security. A major reform issue relates to the ability of taking security over an enterprise. Also, there remains much uncertainty on taking and enforcing security over bank accounts. The Securing Creditor's Claims Law introduced new rules applicable to enforcement of the security. In particular, new modes of extra-judicial enforcement are now provided which allow for the transfer of ownership over the collateral to the creditor, the sale of the collateral directly by the creditor, the assignment of the pledged rights to the creditor or the transfer of funds. However, practitioners remain cautious as to their successful implementation.

Security rights over immovable property (mortgages) are governed by the Law on Mortgage of 5 June 2003 ("Mortgage Law") and the Civil Code's relevant provisions. Mortgage can secure any type of debt as far as it is determinable in monetary terms and the maximum amount has been expressed in the mortgage agreement. Any type of immovable property may be used for security except for agricultural land, for which a moratorium applies until 01/01/2007 (the situation thereafter is unclear) and can only be mortgaged to banks as mortgage creditors. Mortgage right enjoys priority in the mortgaged property from the moment of its entry in the Register. Priority is upheld in practice and in the event of bankruptcy. However, there is some uncertainty as to the precedence of tax liens which are registered in the Register of Encumbrances but enjoy automatic statutory priority by law.

In case of the mortgagor's default, the mortgage right can be enforced without involvement of a court by a direct sale or by a public auction depending on provisions of the mortgage agreement or other agreement concluded subsequently. The mortgage creditor can approach the State Execution Agency, which will conduct the public auction presenting the certified mortgage agreement that has been stamped by a notary (giving it the force of an executory title) and document proving the mortgagor's default. Enforcement is reported to usually take up to 6 months, and the sale proceeds correspond to the asset's market price. However, the current booming real estate market may have eased enforcement, which could be more difficult in a stagnant market. Difficulties are noted in relation to eviction of minors, since the consent of the State Committee for Protection of Rights of Minors is then required.

Mortgage markets participants express full satisfaction on the legal framework and the growth of the market, and the first issue of mortgage-covered bonds confirms this.

### **Telecommunications**

The communications sector in Ukraine is currently governed by the Telecommunications Law of 2003 (the "2003 Telecom Law"), as amended, and is formally regulated by the National Commission for the Regulation of Communications (NCRC). According to sector legislation NCRC's formal regulatory role includes responsibility for licensing and registration of operators, tariff regulation, interconnection, management of numbering resources and resolution of disputes between operators or between operators and consumers. The 2003 Telecom Law dictates that the NCRC be appointed by, and reports to, the President. Policymaking is the responsibility of the Ministry for Transport and Communications (the "Ministry"). Definitive institutional structure of the sector is unclear however, with the president, parliament, cabinet, Ministry, military authorities and anti-monopoly commission all having input to sector policy and regulation.

While the enactment of the 2003 Telecom Law has moved the sector legislative base some of the way towards alignment with European Union (EU) standards, elements of the legal framework require further revision to be harmonised with EU principles for the sector.

Private sector led fully competitive provision of service is fundamental to the successful development of the telecom sector in Ukraine. Liberalisation and privatisation are key to the attraction of private investment. An independent regulator and a transparent, rule based, cost-oriented regulatory regime is essential for meaningful competition to take hold and can do much to enhance investor confidence in Ukraine. Despite recent changes in the legal framework, successive implementation failures continue to result in sector stagnation. While the movement to calling party pays (CPP) has boosted the mobile market, that market remains dominated by two players. Similarly, the fixed market remains dominated by UT with competitive operators making little inroads in the absence of meaningful implementation of the reforms contained in the 2003 Telecom Law.

Going forward the government should re-double efforts to fully implement an EU compliant regulatory framework, revising the legislative framework where necessary.

Key to implementation is the sector regulator, NCRC. Government should immediately move to re-state the institutional structure of the sector, confirming NCRC as the sole independent regulator for the sector, enshrining NCRC independence in law. Key to establishing such independence is providing for NCRC to be appointed by and accountable to parliament and financed through international best practice industry levy. This levy should be set at a level to both provide market reflective salaries to attract sufficiently experienced staff and cover the cost of the full implementation of the 2003 Telecom Law. Additionally, government should fully facilitate NCRC in implementation of all elements of the regulatory framework set out in the 2003 Telecoms Law. NCRC for its part should move swiftly to carry out the market assessments necessary to declare dominant operators to be subject to regulation and pro-actively intervene in segments where competition is absent or insufficient.

## ANNEX 3 SOCIAL ISSUES

The Human Development Index (HDI) for Ukraine is 0.674, which ranks it at 77th out of 177 countries. The proportion of the population living in urban areas continues to increase and is expected to reach 70.2 percent in 2015 (from 67.7 % in 2004). At the end of 2006, according to official statistics from the State Committee on Nationalities and Migration, there were 2,275 refugees in the country. Of these, there were 627 refugees from countries of the Commonwealth of Independent States, including 128 Chechen refugees from Russia.

**Education** is free, universal, and compulsory until the age of 15; however, the public education system has continued to suffer from chronic inadequate funding. Teachers were usually paid their salaries during the year, but other monetary benefits due them were not paid in some localities. Children from poor families continue to drop out of school during the year, and illiteracy, previously very rare, has become more common. The All Ukraine Committee for the Protection of Children reported that lack of schooling remained a significant problem among the rural population. In many areas of the country, poverty often forced Romani families to withdraw their children from school so that they could work to supplement the family income. Roma rights organizations reported numerous incidents of discrimination against Romani children in schools.

**Minority and Vulnerable Groups:** An estimated 400,000 Roma are living throughout the country, mainly concentrated in the Zakarpattia, Odesa, Mykolayiv, and Kyiv regions. Opinion polls have indicated that social intolerance is greater toward Roma than toward any other ethnic group. On June 19 2006, the European Roma Rights Centre (ERRC) submitted a report to the UN Committee on the Elimination of Racial Discrimination about increased discrimination against the Romani community. There were numerous reports of Roma being evicted from housing, removed from public transportation, denied public assistance, kicked out of stores, and denied proper medical treatment.

Crimean Tatars reside in 300 settlements, some of which are not fully developed: only 90 percent of them have electricity, 70 percent water, and 25 percent paved roads. Crimean Tatar leaders had complained that their community, whose members have returned over recent decades after having been forcibly exiled from the Crimea during World War II, were not receiving adequate assistance in resettling. Returning Tatars were given land plots on the peninsula, but only inland, and not along Crimea's desirable southern coast from which Tatars claimed they were exiled. There were almost 8,200 protests about the land issue in 2006, in contrast to 2,500 protests in 2005. In May 2006, the Cabinet of Ministers approved a program to spend \$130 million (675 million hrynia) over the next five years to help settle returning Crimean Tatars and members of other ethnic groups and provide assistance for integrating them into society, including building or purchasing housing. The resolution also allows measures for facilitating the return of cultural property of Crimean Tatars taken out of the country after the deportation and for developing media broadcasting in the ethnic languages.

On May 22, President Yushchenko established a 28-member advisory council of government officials and NGO leaders on ethnic national policy.

Only 13 percent of the country's 2.5 million persons with disabilities were employed, according to statistics from the Ministry of Labour and Social Policy, although the total

number of employed disabled persons increased from 272,000 in 2005 to 344,000 during 2006. The law prohibits discrimination against persons with disabilities in employment, education, access to health care, or other state services. The law mandates access to buildings and other public facilities for persons with disabilities, but it has been poorly enforced. In June 2005 a presidential decree was issued ordering the government to ensure that persons with disabilities could physically access government and public buildings. There were some efforts made to comply with the decree, but most public buildings have remained inaccessible.

**Gender:** The gender empowerment measure of 0.455 ranks it 63rd out of 75 countries, with just 7.1% seats in parliament being held by women. Labour legislation establish the legal equality of men and women, including equal pay for equal work, and this principle was generally observed. However, industries that were dominated by female workers were also those with the lowest relative wages and the ones most likely to be affected by wage arrears.

The law mandates equal legal rights for men and women and establishes legal protections against gender discrimination. However, human rights observers and women's groups have reported that discrimination against women continued to be a common problem in the workplace. The government and private businesses regularly specify the gender of employees in advertisements, and employers frequently demanded information about a woman's family situation and subsequently used it to deny employment to women who were likely to become pregnant. It is reported that physical appearance and age were often taken into account in employment decisions involving women.

**Human Rights:** The law prohibits trafficking in persons; however, there were numerous reports that persons were trafficked to, from, and within the country. The country remained a point of origin for internationally trafficked men, women, and children. The main destinations were Russia, Turkey, Western and Central Europe, particularly Poland and Czech Republic, and the Middle East. The country also was a transit route for individuals from Central Asia, Russia, and Moldova.

Ukrainian and Crimean Tatar minorities have officially complained of discrimination by the ethnic Russian majority in Crimea and called for the Ukrainian and Crimean Tatar languages to be given a status equal to Russian. Crimean Tatar leaders also continued to call for changes in the electoral law that would allow them to achieve greater representation in the Crimean legislature

In 2006, the OSCE, reported that the country lacked effective legal means to combat racism and xenophobia since existing laws require a very high level of proof of prior intent to stir up ethnic hostility. As a result, prosecutors preferred to deal with racist crimes as hooliganism or other simpler to prove offences.

International human rights organizations have criticised widespread discrimination against persons with HIV/AIDS and lack of access to treatment. Although the country's national AIDS law is often held up as a model in the region for incorporating human rights protections for people living with HIV/AIDS, implementation has been weak. Persons with HIV/AIDS continued to face discrimination in the workplace, job loss without legal recourse, harassment by law enforcement, prosecutorial, and judicial authorities, and social isolation and stigmatization within their communities.

**Labour:** The law protects children from exploitation in the workplace, but the government has not always effectively enforced the law. The legal minimum age for employment in most areas of the economy is 16, but in certain non-hazardous industries, enterprises may negotiate with the government to hire employees as young as 15 with the consent of one parent. Children aged 14 can legally work on a short term basis for social services such as orphanages, hospitals, and elderly care and in the agricultural sector with the consent of one parent.

Although the law contains occupational safety and health standards, these frequently were ignored in practice. Lax safety standards and aging equipment are reported to have caused many injuries at work. During the first six months of 2006, there were 9050 reported injuries, including 437 job related fatalities. The number of miners injured in the coal sector during the first half of the year was 3,383, including 78 fatalities. In May 2005 the government established a coal industry development program, as well as working groups to analyse the situation in the mining and metallurgical sector, but these efforts did not result in any substantial improvements in health and safety in the mines.

The law gives workers the right to remove themselves from dangerous work situations without jeopardizing continued employment; however, independent trade unions reported that in practice, asserting this right would result in retaliation or perhaps dismissal by management.

## ANNEX 4 ENVIRONMENTAL DEVELOPMENTS

The Bank's environmental approach to Ukraine continues to reflect and address the country's environmental challenges and opportunities through the Bank's project portfolio, cooperation with other IFIs, international development organisations and regional initiatives.

The financing provided by the EBRD is very diverse and most recently included a wide range of sectors such as general manufacturing, transport and infrastructure, agribusiness, financial sector and small and medium-sized enterprises (SMEs) as well as private equity, municipal environmental infrastructure, steel and energy sectors. Special attention is being given to further reforming the energy sector and introducing innovative energy efficient and energy saving technologies across major sectors. The Bank will continue to structure projects so they meet the Ukrainian and EU environmental standards and maximise environmental benefits.

**Nuclear safety** remains to be key, with the EBRD-managed Chernobyl Shelter Fund helping the country to enhance safety of the Chernobyl shelter through the stabilisation programme and the construction of a new safe confinement as part of a comprehensive long-term strategy in the Shelter Implementation Plan (SIP) for the conversion of the 'sarcophagus' into a stable and environmentally safe system. Despite delays caused by the need to properly review the tender process, the implementation of this project is progressing. Following its implementation, the environment is expected to be shielded from accidental release of radioactive dust. The Bank continues to monitor compliance with relevant environmental, health and safety standards that apply to this project

The programme for the safety upgrade for unit 2 of Khemelnitsky and unit 4 of Rovno nuclear power plants (K2R4) is under way and is supported partly by the EBRD loan. This is part of Ukraine's ongoing efforts to achieve significant progress in enhancing nuclear safety on a broader level, including a modernisation programme for all nuclear power plants in Ukraine to upgrade all its 15 nuclear reactors to internationally recognised nuclear safety level by 2010. The EBRD, alongside other international organisations such as European Commission, recognise the substantial efforts undertaken by Ukraine and welcome the consistent and successful implementation of the internationally agreed measures.

In **power and energy** sector the Bank focuses its attention on projects in power generation, transmission and energy efficiency projects. Projects such as Ukrainian Energy Services Company (UkrESCO), investing EBRD-supplied finance in energy efficiency projects, are a flagship effort of the Bank alongside the Ukrainian authorities to cut energy costs in the country. The aim is to show clients from different sectors of the economy where and at what cost they waste energy, and then to provide and finance solutions to enhance their energy efficiency and reduce energy waste.

Atmospheric pollution has traditionally been a by-product of Ukraine's vast **steel industry**, which ranks as the seventh largest in the world. In this industry the Bank continues applying big efforts to improve energy efficiency. This includes a number of advanced operations in steel industry such as, for example, support of the ISTIL steel mill, financing cogeneration facility at Alchevsk steel works or helping Mittal Steel

Kriviy Rih to upgrade their technology and become more energy efficient. ISTIL project includes a number of measures that do not only bring client's operations in compliance with EU IPPC directive, but are expected to improve the company's overall energy efficiency and cut its CO<sub>2</sub> emissions, allowing to generate and sell Euro 3 million of carbon credits. Also some comprehensive training, monitoring and accident investigation procedures have been included into the company's worker health and safety program. The new cogeneration facility at Alchevsk steel works, financed by the Bank, will help to use waste gases and coke oven gases from the production process to produce electricity, therefore significantly reducing greenhouse gas emissions in Ukraine. According to initial assessment, this investment could reduce annual carbon emissions from the steel works by about 6 million tonnes, generating carbon credits and making it potentially a perfect JI project under the Kyoto Protocol mechanisms. Additionally, the project will also help the client to set best international standards of environmental management, improve overall environmental conditions and help to bring levels of atmospheric pollution to the EU standards.

In **general industry operations**, the Bank will apply rigid standards as well as actively promote voluntary and market-based mechanisms for ensuring environmentally sound and sustainable supply of raw materials. This will be a particular focus in the Bank's activities in sectors, which utilise significant amounts of natural resources, such as wood. A number of projects in the Bank's current pipeline involve brownfield site developments. In absence of adequate national regulatory framework, the Bank will require clients to adhere to international environmental and quality management standards, as well as best industry practices. The EBRD will continue to ensure that appropriate site assessments, remediation and/or containment measures are being undertaken. Where general manufacturing operations have potential for improving their energy and resource efficiency, the Bank will help clients to incorporate those into their investment and corporate environmental management plans.

In the **municipal environmental infrastructure** sector, the Bank is concentrating its efforts on improving water and wastewater treatment facilities, urban transport and district heating projects. For example, Dnipropetrovs'k Municipal Water and Wastewater project became effective, aiming to improve quality of water supply and wastewater services in the City of Dnipropetrovs'k. This project will help to achieve EU drinking water and effluent discharges standards, substantially reducing pollution to the Dnipro River and the Black Sea basin caused by the discharge of insufficiently treated sewage. The project will lead to improvements of drinking water quality and the reliability of the water supply system, reducing wastage of drinking water through better demand-side management and leakage prevention. Further efforts of the Bank in direct lending to municipalities will concentrate on raising environmental standards in Ukrainian municipal services sector.

In the **shipping industry**, through the existing and future projects the Bank intends to bring the client's operations into compliance with the IMO, MARPOL and SOLAS requirements. The Bank actively cooperates with other international organisations to improve shipping standards in Ukraine. EBRD-supported project of expansion of Odessa-based shipping company Black Sea Shipping Management Co Ltd. (BSSM) will help the client to maintain its ability to offer safe and reliable shipping services in the

region as well as to establish the relevant shipping standards, adhering to the relevant international environmental and safety requirements.

In the **property development** sector, environmental due diligence will include coverage of environmental, health and safety issues including life and fire safety issues in public buildings. The Bank will require compliance with the best construction practices in property developments and will need its clients to adhere to national labour laws as well as the standards and requirements set by the International Labour Organisation (ILO).

The Bank continued to ensure smooth implementation of its environmental procedures for intermediated financing through local banks in equity and debt operations, including financing for small and medium sized enterprises and micro loans, for residential mortgaging, leasing and insurance sectors throughout its extensive and growing portfolio of **financial intermediary (FI)** operations in Ukraine. In May 2006 the Bank has conducted an environmental due diligence training for its FIs in Ukraine, covering a wide spectrum of environmental and social risk management issues, to ensure adequate implementation of the Bank's policy requirements. The Bank will continue to actively monitor environmental performance of its FI clients in Ukraine on the basis of their annual environmental reports and designated monitoring visits that include meetings with the management of the EBRD's FIs in Ukraine and visits to selected sub-projects.

In line with the increased effort to improve **monitoring** of the Bank's business operations, a number of direct investment and financial intermediary operations have been closely monitored throughout 2006 and scheduled for monitoring in 2007. These projects include Euroventures fund, Rubizhansky Cardboard and Packaging Mill, UkrEsco II, ADM-Risoil Ukraine, Uksnab, Slobozhanska Budivelna Keramika (SBK), Chumak II and Mittal Steel Kryviy Rih. From these visits it is clear that more effort will need to be placed in such areas as occupational health and safety, environmental management capabilities, consistency of annual environmental reporting, diligent implementation and regular update of the respective Environmental Action Plans.

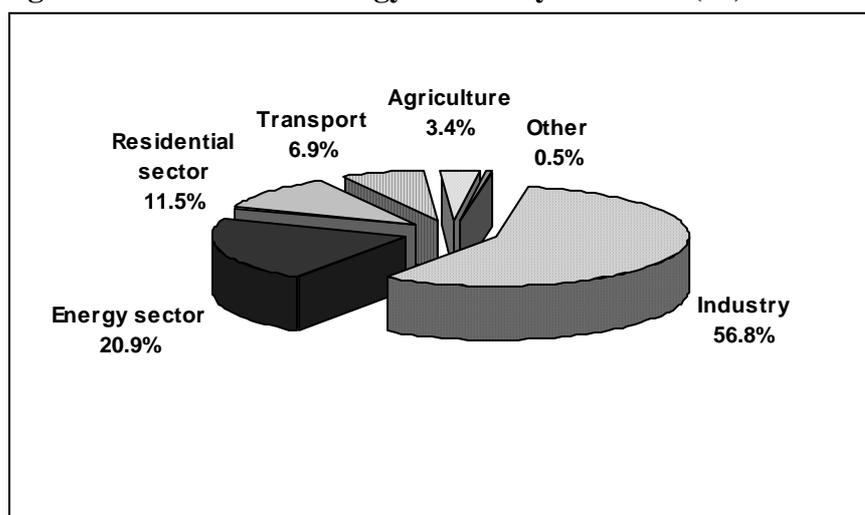
The Bank has a number of **agribusiness** projects in Ukraine each of which has undergone an environmental appraisal in accordance with the Bank's Environmental Procedures and had a thorough assessment of environmental risks associated with it. The Bank is concentrating its efforts on developing new opportunities in food processing and production, food packaging, retail trade, development of the grain origination and logistics market. Projects include, *inter alia*, breweries, malteries, production of edible oils, and manufacture of glass containers. Typical due diligence in these cases includes independent environmental audits to assess current state of facilities and operations, assessing regulatory compliance issues, potential environmental liabilities and opportunities for further environmental improvement. An environmental analysis is usually conducted to assess impacts associated with the proposed investment plans that usually include rehabilitation and refurbishment efforts, expansions or new developments. The Bank will continue to apply this approach, particularly emphasising compliance with European Union standards.

## 1. BACKGROUND

Ukraine has enormous potential for energy efficiency. The Ukraine's Energy Strategy (approved by the Government in April 2006) calls for a more than 50% reduction in energy intensity by 2030. This would correspond to energy savings of 223 Mtoe. The government anticipates that 84 Mtoe, or 38%, of these savings would come from structural changes, as the economy shifts away from heavy industry to a more service-oriented GDP. An even larger share of the reduction would result from technological improvements. To achieve this target about USD 20 billion should be invested in energy efficiency.

According to the IEA's "Ukraine: Energy Policy Review 2006", about 21% of the total energy saving potential is to be found in the energy sector itself, 57% in industry, 11% in housing and communal services (utilities), and 7% in transport (Figure 1). This estimate is based on wider use of existing technology, not new technological improvements.

**Figure 1. Structure of Energy Efficiency Potential (%)**



*Source: Ukraine: Energy Policy Review 2006, IEA.*

### **Industrial Energy Use and Intensity**

Ukrainian industry accounts for 40% of total final consumption of energy (IEA). Within the industry, energy use is concentrated in a few energy-intensive sectors – metallurgy, chemicals, and cement. Other promising sectors for energy efficiency improvements are petrochemicals, construction materials, and glass.

The ratio of energy consumed per tonne of industrial output is very high in Ukraine compared to other industrialised countries of the OECD. This is especially true in metallurgy. According to IEA and Ukrainian estimates, Ukraine consumes three times

as much energy to produce one tonne of cast iron and twice as much to produce steel as the OECD European average. Ukraine's chemical sector consumes three times as much electricity to produce one tonne of ammonia as the United States and about two times as much as Russia. Cement is manufactured using an inefficient wet process, rather than a dry process, consuming 70% more energy to produce one tonne of cement than OECD countries.

According to the IEA estimates, energy savings in industry can reach 30-40% of current consumption. These numbers can be even higher when manufacturers introduce totally new production processes (as with modern steel technologies). Even at 2005 prices, most plants could cost-effectively improve efficiency by up to 20%; energy prices have risen significantly since then.

The technological options for energy efficiency improvements in the industry include general energy efficiency measures (heat recovery, installation of efficient compressed air stations, replacement of steam traps) and industry specific measures like recovery of excess coking gas to generate energy in coking plants.

### ***Power***

Most thermal power stations in Ukraine have already exceeded their useful life. In 2004, the average age of large thermal power blocks was 36 years; the average age of large cogeneration plants was 42 years. The average technical losses during electricity transmission and distribution currently amount to about 15% (8% in 1990) compared to 6% in the OECD.

There are numerous cost-effective options for energy efficiency improvements in the Ukrainian power sector: installing cogeneration units and upgrading existing ones, utilising heat from flue gases, supplying power units with technologically appropriate fuel, enhancing the efficiency of service equipment which draws energy from the power plant (e.g. blowers, pumps and conveyor belts), enhancing turbine inlet temperature, pressure ratios or compressor efficiency and capability.

### **District Heating**

District heating systems account for 45% of Ukrainian natural gas consumption; the energy efficiency potential in this sector is enormous. Energy consumption for heating Ukrainian buildings is two times higher than in OECD Europe. Residential energy consumption, in which district heating accounts for at least one-quarter of the energy consumed amounted to 29% of total final consumption in 2004 (IEA). Most district heating distribution networks are outdated and poorly insulated, with losses of up to 30%. In addition, poorly insulated buildings lose about 30-50% of the heat delivered.

Project options for energy efficiency improvements include replacement and upgrading of boilers, switching to cogeneration, improvements in the heat transportation network and at heat consumption level.

### **Building Stock**

Residential and public buildings are responsible for a considerable share of national energy consumption. Residential buildings alone consume more than 30% of the energy used in Ukraine; commercial and public services (which are often located in buildings) consume another 10% of the energy. Both of these sectors have seen their share in total energy use grow in the past decade. Overall, there is substantial potential to save energy in Ukrainian buildings, especially those connected to district heating.

## **Renewable Energy**

In Ukraine, the share of renewable energy in domestic energy supply is insignificant, about 0.7%. Most of the country's renewable energy today is concentrated in hydropower and biomass-fired heating boilers. There are also several wind power plants (with total capacity of about 70 MW) and geothermal heating systems (13 MWth).

The Energy Strategy to 2030 estimates that Ukraine will nearly quadruple its use of renewable energy from 10.9 Mtoe in 2005 to 40.4 Mtoe in 2030. This would require investing some UAH 60.4 billion (USD 12.6 billion) in the sector. The highest growth is expected in the use of bioenergy, solar energy and low-potential heat, although the growth will start from a very low base.

The most significant challenges in expanding renewable energy are cost competitiveness and underdeveloped regulatory framework. For example, wind power tariff (feed-in tariff) in Ukraine is UAH 0.24 (USD 0.05) / kWh, while the nuclear tariff is only UAH 0.08 (USD 0.016). Direct and hidden subsidies for traditional energy, as well as other market distortions, effectively work against broader use of renewables in Ukraine.

## **2. BARRIERS TO ENERGY EFFICIENCY INVESTMENTS**

There are a number of barriers which hinder EBRD investments in energy efficiency in Ukraine. The most significant barriers are described below.

- *Slow progress in tariff reform, liberalisation and privatisation* – despite significant energy price increase during the last year, electricity and natural gas (especially for households) remain below the long-run marginal costs. Prices for renewable energy (hydro, wind) are too low at the moment. Apart from that, existing cross-subsidies and other distortions deflate prices for many energy products. Residential consumers, public institutions and agricultural users obtain energy at a relatively low, regulated rate and consumers have no ability to choose an energy supplier, nor can they regulate their consumption. For instance, residential consumers are unable to regulate heat consumption and therefore do not have incentives to save energy. Such situation undermines the consumers' willingness to pay energy bills and the whole idea of tariff reform.
- *Legislation and regulatory framework* do not stimulate investments in energy efficiency and renewable energy. While a number of laws and decrees to promote energy efficiency and renewable energy have been recently passed, incentives or other supporting mechanisms do not exist or are very bureaucratic / overregulated. For instance, the law on Combined Heat and Power and Waste Energy Potential was adopted in 2005, but the cogeneration still has a very low share in Ukraine due to the

absence/inconsistencies of the sub-law/regulatory mechanisms, e.g. the grid access, licences, power purchase agreements etc. Apart from that, legislation barriers exist for state-owned energy companies to provide collateral, for ESCOs to undertake Energy Performance Contracts, for state and municipal budget organisations to benefit from energy savings.

- *Lack of management focus and second priority to investing for revenue growth.* The key challenge in Ukraine is to convince the client explaining how the energy efficiency can generate additional revenues. Besides, many Ukrainian enterprises focus only on the operational improvements paying much less (if any) attention to the energy infrastructure (supply) of the company which is also obsolete and wastes a lot of energy. Apart from that, a significant barrier, at least for many Ukrainian ESCOs, is to get access to the decision makers (the enterprise's owners) as most enterprises are now privatised and do not want to disclose the basic information on energy consumption.
- *Lack of long-term capital and high initial cost* are still significant barriers in Ukraine. Loan maturities remain relatively short (typically 2-3 years), margins relatively high (12 per cent or more) and the NBU rules encourage over collateralisation (150 per cent or more). Although the incremental investment relative to a less energy-efficient technology may be paid back fairly quickly from energy savings and other benefits, the high initial cost acts as a barrier for consumers lacking in capital, particularly in situations where financing mechanisms to spread the cost over time are not readily available.
- *Limited knowledge about financing energy efficiency and renewable energy* resulting in Ukrainian banks / investors being unwilling to take project risk. With the exception of UkrESCO, backed up by the EBRD loan, Ukrainian ESCOs are generally unable to take financial risks. In addition, many of the financial mechanisms commonly used in western countries to facilitate investment in energy efficiency, such as equipment leasing or energy performance contracting, are not often used in Ukraine.
- *Lack of skilled energy managers and energy auditors.* While there is no shortage in the technical expertise, the project management and business planning skills are rare among the energy experts. Dedicated in-house energy management expertise to assess and promote energy efficiency projects is also not common in Ukraine. In monopoly and state-protected enterprises managers have little incentives to minimise energy costs or innovate. Moreover, responsibilities for energy expenditures and energy conservations often belong to different decision makers.
- *Lack of information about technologies, opportunities, costs, and benefits.* Proven, cost-effective technologies are often perceived as risky because there is still little experience with them in some Ukrainian plants. The lack of visible installations and the lack of familiarity and experience with renewable energy technologies leads to perception of greater technical risk than for conventional energy sources.

### **3. OPERATIONAL PRIORITIES**

#### **General Industry and Agribusiness**

The projected growth of the Bank's operational activity in the general industry provides opportunities for significant energy efficiency investments. The Sustainable Energy

Initiative the Bank can accelerate the pace of these investments and add significant value by:

- Supporting existing projects:
  - Identifying energy efficiency investment opportunities at the exploratory stage;
  - Participating in marketing with other bankers (site visits; initial discussions with clients);
  - Providing implementation support – in particular energy management training – to ensure investments do take place and facilitate the transfer of skills to enhance the sustainability of activities;
- Originating new projects with large energy efficiency and/or carbon financing component:
  - Identifying new hot spots / specific large energy users both in regional and sectoral terms. Many industrial enterprises have already undertaken energy audits or feasibility studies under the various TA programmes (USAID etc) but have put them off because of the low-priced energy and the lack of business planning skills. The recent USAID Industrial Energy Efficiency Initiative aimed at 10-15 large natural gas consumers could bring potentially 2–3 large energy efficiency projects.
  - Approaching large energy-intensive enterprises directly, raising their awareness on the EBRD financing mechanisms and its energy efficiency agenda. Energy audits and trainings with no up-front cost will encourage clients to work with the EBRD. Contacts can be established through participation in the clients' corporate events, investment summits, energy conferences etc.
  - Working with the sector-specific organisations such as the Ukrainian League of Industrialists and Entrepreneurs, the Union of Metallurgists etc. who comprise about 32,000 enterprises and have a very developed network (offices) and relations with all 25 oblast administrations in Ukraine.
  - Taking off large projects (more than EUR 5 million) identified by the UKEEP marketing activity (road-shows and seminars, project consultants' visits to the plants, participating banks' proposals etc).
  - Identifying carbon finance opportunities and working with clients to facilitate carbon credit transactions through the Multilateral Carbon Credit Fund (MCCF)
  - Organising a national competition on the Best Energy Efficiency Plan among large energy consumers, providing them with free energy audits and other benefits.

### **Working through Financial Intermediaries (Sustainable Energy Financing Facility) – Ukraine Energy Efficiency Programme**

The Ukrainian Energy Efficiency Programme (UKEEP) was launched in early 2007. The project envisages EUR 100 million financing to be provided in the form of a credit line to Participating Banks (“PBs”) where the PB will on-lend to private sector industrial entities for energy efficiency and renewable energy investments. UKrExim and Kreditprom will be the first PBs under the Programme for up to USD 50 million and USD 10 million respectively.

Technical assistance will be provided in order to market the programme, identify and appraise potential investments and conduct energy audits where necessary. The consultants engaged will perform a review of the specific sub-borrower's procurement arrangements which will be included at either the screening stage or in the energy audit report.

## **Power and Energy**

All projects in Ukraine's energy sector considered by the Bank have significant associated energy efficiency or renewable energy benefits. The transmission line projects and Kaniv Hydro Pump Storage Station Construction project will result in energy efficiency gains by allowing flow between regions that otherwise could not exchange power as well as reducing the need for new generation in these regions.

Ukraine currently has a very low share of cogeneration in its electricity and heat production. In principle, Ukraine's large district heating load creates a very favourable market environment for cogeneration. The Bank will seek to increase its financing of cogeneration capacity – whether for on-site industrial needs, to provide district heat or to sell power into the local distribution network.

All the projects envisage substantial reduction of GHG emissions and, therefore, can generate a large pipeline of carbon credits for The Multilateral Carbon Credit Fund (MCCF). The preparation work can benefit substantially from the existing baseline approach for determining the Ukrainian grid factor (the carbon dioxide density per kWh), assessment of which has been recently conducted by TUV SUD Industrie Service GmbH and submitted to the Ukrainian Government.

## **Renewable energy**

The EBRD has identified approximately 500MW of renewable energy projects under development in Ukraine. These projects have received some support from international investors but are unable to proceed to construction and operation phase because the support mechanisms required to make renewable energy projects viable are currently undeveloped.

The Bank aims at promoting, supporting and investing in the development of renewable energy in Ukraine. In 2007 – 2009 the work will focus on the following activities:

- Regulatory support – detailed legal assistance to prepare / improve the regulatory framework for renewable energy. The possible Terms of Reference for such assistance is being considered and discussed with the key policymakers – the National Agency on Energy Efficiency (NAEE) and the Parliamentary Committee on Fuel and Energy. This work will include technical resource assessment (wind resource maps, assessment of grid constraints) as well as assessment of local capability and identification of training needs;
- Technical assistance to renewable energy project scoping;
- Capacity building – training of bankers from the PBs participating in the UKEEP, sharing the experience of the EBRD renewable energy support in other countries (Croatia, Hungary, Bosnia) as was requested by the Parliamentary Committee on

Fuel and Energy;

- Support to the RO bankers (mainly in agribusiness) with bio-diesel and bio-ethanol project proposals the number of which has increased substantially
- Support to the PEU team in originating and/or assessing small hydro projects, which are expected to become bankable due to recent legislation improvements.

### **Municipal and Energy Infrastructure**

The Bank is actively working on a number of District Heating projects. All those projects are energy efficiency projects with substantial investments in both supply side (new cogeneration units, modernisation of heat-boilers etc) and demand side (new meters, heat points, insulation etc).

By purchasing the carbon credits the MCCF could provide additional cash-flow to these projects, making them more financially robust.

The Bank will also seek to facilitate these projects by providing support through institutional strengthening of the residential sector. Institutional changes, e.g. promotion of condominiums or housing co-operatives, are crucial to improving energy efficiency in district heating. Cost-reflective prices can provide incentives to save energy if only consumers are able to meter and regulate their energy consumption. The current unclear ownership and management structure in the building sector is a major barrier for energy efficiency investments. The main issues are that no one is really responsible for the common parts of the building, including district heating pipelines, and households have no incentives to organise condominiums and effectively manage their buildings.

The need for reforms in this area is recognised by the Ukrainian government and the EU is considering providing the technical assistance. In particular, the NAEE has requested a EU grant for the preparation of an inventory/survey of the housing stock in Ukraine. The scope and size of this assistance is under consideration at the moment.

### **Natural Resources**

There are a number of projects under consideration by the NR team in Ukraine. All the projects envisage the substantial reduction of methane emissions and, therefore, can generate a large pipeline of carbon credits for the MCCF.

Another area for Bank involvement is coalmine methane projects, which have a high emission reduction potential in Ukraine, especially in the Donetsk coal basin. Underground coalmines emit around 25 million tons of CO<sub>2</sub> equivalent from methane per year. Currently, mainly for safety reasons, coalmines are degasified and the methane simply ventilated into the atmosphere or used for heat production in mine boilers instead of being recovered for electricity production.

## **4. CARBON MARKETS AND THE MCCF**

The last national communication of Ukraine and its latest Greenhouse Gas (GHG) inventory set forth that notwithstanding recent economic growth in Ukraine the level of GHG emissions will remain significantly below its Kyoto Protocol target. In effect, it is likely that Ukraine will have a surplus of over two billion Assigned Amount Units (AAUs) during the first Kyoto commitment period of 2008-2012 compared to its base year 1990.

### **Project Based Transactions under Joint Implementation (JI) Arrangements**

[The Multilateral Carbon Credit Fund](#) has been established to enable several Member States (along with private participants) to purchase carbon credits from Greenhouse Gas (GHG) emission reduction projects. MCCF became operational at the end of 2006. The fund will buy carbon credits from investments under the European Union scheme as well as the Protocol's Joint Implementation and Clean Development Mechanism (of these three JI is the one which applies in Ukraine).

### **Green Investment Schemes**

The MCCF will also aim to facilitate the direct trading of carbon credits between some of its shareholders (so-called Green Investment Schemes) based on the availability of AAUs to be allocated to such schemes. Under such Green Investment Schemes ("GIS"), the selling country uses the revenue from the sale of AAUs to support investments in climate friendly projects.

In addition the Bank could play a leading role in promoting and supporting the Ukrainian Ministries of Environmental Protection and of Fuel and Energy to participate in the market for GIS. Any such green AAU trading would need a robust GHG inventory, monitoring and regulatory system to be in place and the EBRD is considering providing technical assistance to strengthen Ukraine's compliance with Kyoto Protocol. Given a strong donor interest to provide a significant funding (up to EUR 1 million) for carbon market support, the EBRD could support the Ministries of Environmental Protection and of Fuel and Energy to develop a framework for GIS.

The work related to JI and GIS would envisage the following in co-operation with the MCCF Secretariat and Carbon Manager:

- Follow-up meetings with sovereign stakeholders, being the Ministry of Environmental Protection, Ministry of Fuel and Energy and Ministry of Finance, in order to further promote i) GIS developments, ii) full Kyoto Compliance (meeting article 17 eligibility criteria) and iii) development of JI track I procedures.
- To respond to the Technical Assistance request from the Ministry of Environmental Protection for capacity and institution building by developing and implementing a TC project, the objective being to strengthen Ukraine's position in the carbon market.
- Follow-up meetings with the Management of SJSC UkrEnergo (owner of power transmission lines) to discuss the possible technical assistance in relation to structuring JI and GIS proposals for the MCCF;
- To develop a concrete GIS proposal whereby the AAU sales proceeds would be

used to co-finance a Sustainable Energy Financing Facility

- To further identify opportunities for JI and GIS, e.g. large scale wind, renewables, coal bed methane, rehabilitating gas transmission and distribution networks, waste (water) management and district heating

## **5. POLICY DIALOGUE**

The EBRD will work with the Ukrainian government to emphasise the importance of energy efficiency as a solution to broader challenges for Ukraine such as energy security and economic competitiveness. This will include the following activities:

- Further developing cooperation with NAEE – the main executive body responsible for energy efficiency and renewable energy policy making in Ukraine. Technical assistance can be provided to improve the regulatory framework, which is being developed by the NAEE, in the following areas:
  - development of renewable energy, in particular small hydro, wind, and biomass;
  - promotion of cogeneration, both industrial and municipal;
  - housing sector institutional reform – promotion of condominiums (housing co-operatives/associations)

These areas are targeted by the EC funds, in particular the establishment of the new biomass ESCO and the preparation of the housing stock inventory.

- Providing support to the Ministry of Fuel and Energy, which has taken the lead in developing the renewable energy legislation in Ukraine, in particular on small hydro and “green energy tariffs”. Assistance on the legislation review and methodology guidance for green tariffs has been requested and the possible scope of the EBRD involvement (within proposed TC) has been discussed.
- Working with the Ministry of Fuel and Energy and the Ministry of Environmental Protection on full Kyoto compliance, the development of GIS mechanisms and JI Track 1 procedures, as well as related capacity and institution building . The MCCF Secretariat may provide support in the development of the GIS mechanisms.
- Advancing the work with the Finance Ministry on recently launched (but not effective yet) mechanism of low-interest loans to the energy efficiency and renewable energy projects.
- Improving the work with oblast’ administrations. They all have the energy efficiency departments which collect the information on potential energy efficiency projects proposed by the companies in the region.

## **6. DIALOGUE WITH DONORS**

Establishment and support of the Energy Efficiency/Renewable Energy dialogue with donors would envisage the following activities:

- Regular meetings with lead donors: WB, USAID, UNDP to establish good working relations / synergy in the area of energy efficiency.
- Exploring new opportunities to work with the EU on Energy Efficiency/Renewable

Energy, in particular in the areas identified by the relevant roadmap on implementation of the 2005 EU-Ukraine MoU on energy cooperation

- Establishing a dialogue with bilateral donors which are active in the area of energy efficiency, finding a niche where the EBRD could add value (or the programmes could add value to the EBRD) to accelerate Ukraine's progress on energy efficiency. For example Germany has allocated EUR 80 million to support energy efficiency projects in Ukraine; and Britain is launching a large project on raising public awareness in energy efficiency. Many other developed countries have expressed the willingness to support Ukraine's aspirations to improve energy efficiency and renewable energy development. Given its investment experience, the EBRD could support this process.
- Participating in the seminars / workshops organised by the donors in the field on energy efficiency (co-organise the first seminar with the EC Delegation has been requested)

## ANNEX 6 SELECTED ECONOMIC INDICATORS

### Ukraine

	2001	2002	2003	2004	2005	2006	2007
						<i>Estimate</i>	<i>Projection</i>
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	9.2	5.2	9.6	12.1	2.6	7.1	6.8
Private consumption	9.0	9.5	11.5	13.1	16.6	14.4	na
Public consumption	10.4	-6.7	6.9	1.8	2.7	4.8	na
Gross fixed capital formation	6.2	3.4	22.5	20.5	-0.3	18.7	na
Exports of goods and services	3.5	7.4	10.3	21.3	-11.2	-4.9	na
Imports of goods and services	6.0	3.3	16.4	15.5	2.1	6.5	na
Industrial gross output	14.2	7.0	15.8	12.5	3.1	6.2	na
Agricultural gross output	10.2	1.2	-9.9	19.1	0.4	1.0	na
<b>Employment</b>							
	<i>(Percentage change)</i>						
Labour force (end-year)	-0.1	0.5	0.3	0.0	0.4	-0.5	na
Employment (end-year)	1.7	0.3	-6.0	0.7	1.9	0.2	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year) <sup>1</sup>	3.7	3.8	3.6	3.5	3.1	2.7	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	12.0	0.8	5.2	9.0	13.5	9.1	11.4
Consumer prices (end-year)	6.1	-0.6	8.2	12.3	10.3	11.6	10.5
Producer prices (annual average)	8.7	3.0	7.6	20.4	16.7	9.6	na
Producer prices (end-year)	0.9	5.7	11.1	24.1	9.5	14.1	na
Gross average monthly earnings in economy (annual average)	35.2	20.9	22.9	27.9	36.4	29.7	na
<b>Government sector<sup>2</sup></b>							
	<i>(In per cent of GDP)</i>						
General government balance	-0.9	0.1	-0.7	-4.4	-2.3	-1.3	-2.7
General government expenditure	34.4	35.6	37.2	39.5	42.0	43.0	na
General government debt	36.9	33.5	29.3	25.9	19.7	16.5	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	43.2	42.3	46.9	32.8	53.9	34.3	na
Domestic credit (end-year)	21.9	28.0	38.4	24.8	34.3	69.4	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	22.1	28.5	35.3	36.4	43.8	48.2	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Refinancing rate	12.5	7.0	7.0	9.0	9.5	8.5	na
Deposit rate <sup>3</sup>	11.0	7.9	7.0	7.8	8.6	7.6	na
Lending rate <sup>3</sup>	32.3	25.4	17.9	17.4	16.2	15.2	na
	<i>(Hryvnias per US dollar)</i>						
Exchange rate (end-year)	5.3	5.3	5.3	5.3	5.1	5.1	na
Exchange rate (annual average)	5.4	5.3	5.3	5.3	5.1	5.1	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	1,402	3,173	2,891	6,804	2,531	-1,617	-4,680
Trade balance	198	710	-269	3,741	-1,135	-5,194	-8,180
Merchandise exports	17,091	18,669	23,739	33,432	35,024	38,949	44,791
Merchandise imports	16,893	17,959	24,008	29,691	36,159	44,143	52,972
Foreign direct investment, net	769	698	1,411	1,711	7,533	5,336	5,500
Gross reserves, excluding gold (end-year)	2,955	4,241	6,731	9,302	19,413	22,300	na
External debt stock <sup>4</sup>	12,098	12,771	23,811	30,647	39,619	54,286	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	1.7	2.4	2.9	3.2	5.3	5.0	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service <sup>5</sup>	8.7	5.7	6.2	4.6	4.9	5.1	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	48.5	48.0	47.6	47.3	47.1	47.1	na
GDP (in billions of hryvnias)	204	226	267	345	441	538	640
GDP per capita (in US dollar)	785	883	1,053	1,371	1,831	2,259	na
Share of industry in GDP (in per cent)	27.1	27.4	27.2	25.8	25.6	na	na
Share of agriculture in GDP (in per cent)	14.4	13.0	10.9	10.8	9.2	9.2	na
Current account/GDP (in per cent)	3.7	7.5	5.8	10.5	2.9	-1.5	-3.7
External debt - reserves (in US\$ million) <sup>4</sup>	9,143	8,530	17,080	21,345	20,206	31,986	na
External debt/GDP (in per cent) <sup>4</sup>	31.8	30.1	47.5	47.3	46.0	51.0	na
External debt/exports of goods and services (in per cent) <sup>4</sup>	57.4	54.7	82.2	77.2	89.3	108.1	na

<sup>1</sup> Officially registered unemployed. According to ILO methodology, the rate of

unemployment in Ukraine is higher than the official rate.

<sup>2</sup> General government includes the state, municipalities and extra-budgetary funds.

<sup>3</sup> Weighted average over all maturities.

<sup>4</sup> Until end-2002, medium and long-term external debt only. From 2003 onward, the series also includes short-term external debt.

<sup>5</sup> Refers to payments on official debt only.

ANNEX 7 SIGNED COMMITMENTS AND PIPELINE

**Signed EBRD commitments, 25 May 2007 (in €million)**

Op Name	Regional/Direct	Signing Date	Total Project Value	EBRD Finance	Debt	Equity	Operation Stage
AD-Zarya	Direct	05/02/98	42.6	12.8	0.0	12.8	Completed
ADM-Risoil Ukraine	Direct	25/04/05	15.3	7.4	7.4	0.0	Repaying
AIG New Europe Fund	Regional fund investment	29/06/99	24.8	4.6	0.0	4.6	Repaying
AIG New Europe Fund II	Regional fund investment	15/11/06	2.5	4.0	0.0	4.0	Disbursing
AVAL Mortgage Credit Line	Direct	28/10/04	7.4	7.4	7.4	0.0	Signed
AVAL SME II Loan Facility	Direct	19/06/06	37.2	37.2	37.2	0.0	Disbursing
Accession Mezzanine Capital II	Regional fund investment	16/01/07	20.0	4.0	0.0	4.0	Disbursing
Air Navigation System Upgrading	Direct	26/02/98	33.1	19.8	19.8	0.0	Repaying
Alliance ScanEast Fund	Regional fund investment	01/04/94	9.5	3.3	0.0	3.3	Completed
BNP Dresdner Ukraine	Direct	06/03/98	9.0	1.0	0.0	1.0	Completed
BSR Europe Co-Investment Facility	Regional fund investment	14/08/06	3.5	3.5	0.0	3.5	Signed
Balkan Gas Transit II	Direct	21/11/01	92.3	37.6	37.6	0.0	Repaying
Balkan Gastransit Project	Direct	21/12/99	67.0	29.8	29.8	0.0	Repaying
Baring Vostok Private Equity Fund	Regional fund investment	13/12/00	4.0	1.8	0.0	1.8	Disbursing
Baring Vostok Private Equity Fund III	Regional fund investment	21/12/04	74.8	9.1	0.0	9.1	Repaying
Baring Vostok Private Equity Fund IV	Regional fund investment	14/02/07	37.2	2.2	0.0	2.2	Disbursing
Barlinek	Direct	06/11/06	45.0	19.5	19.5	0.0	Disbursing
Billa	Regional fund investment	20/03/03	62.9	7.9	7.9	0.0	Completed
Black Sea Fund	Regional fund investment	26/08/98	5.1	2.0	0.0	2.0	Disbursing
Black Sea Shipping Management Co. Ltd (BSSM)	Direct	21/09/06	25.3	7.4	7.4	0.0	Repaying
Bluehouse equity fund	Regional fund investment	17/10/06	1.3	1.3	0.0	1.3	Repaying
Bosch Service Franchisee Framework	Direct	06/12/01	3.1	3.1	3.1	0.0	Repaying
Bunge BSI	Direct	28/04/06	27.5	13.4	13.4	0.0	Disbursing
Bunge Loan Increase	Direct	27/12/06	7.4	3.7	3.7	0.0	Disbursing
Cadogan Petroleum	Direct	23/02/07	8.8	6.2	0.0	6.2	Disbursing
Cantik Equity Investment	Direct	23/02/07	25.9	11.5	0.0	11.5	Disbursing
Capital Media	Regional fund investment	21/07/06	60.0	30.0	30.0	0.0	Disbursing
Cargill Industrial Complex	Direct	30/06/99	66.1	36.3	36.3	0.0	Completed
Cargill Ukraine: Warehouse Receipt Program	Direct	03/12/01	11.2	11.2	11.2	0.0	Completed
Cargill Ukraine: Warehouse Receipt Program Harvest 2003	Direct	06/06/03	11.2	11.2	11.2	0.0	Completed
Cargill Working Capital Facility	Direct	17/06/04	11.2	11.2	11.2	0.0	Completed
Cerealía BCP	Direct	29/06/00	7.3	2.1	2.1	0.0	Completed
Cereol Ukraine	Direct	01/02/02	30.9	19.7	19.7	0.0	Completed
Cersanit Invest	Regional fund investment	11/04/07	42.6	20.2	20.2	0.0	Signed
Chumak	Direct	30/06/04	13.7	10.1	10.1	0.0	Completed
Chumak II	Direct	09/12/05	36.3	27.9	27.9	0.0	Disbursing

Consumers Sklo Zorya	Direct	17/04/03	16.5	10.9	10.9	0.0	Completed
Credit Facility to AVAL under Tranche 3 of Ukraine SME II	Direct	19/12/03	11.2	11.2	11.2	0.0	Repaying
DIF - Ukram Industries	Direct	17/07/01	2.1	2.1	0.0	2.1	Disbursing
DIF - Ukram Industries Loan	Direct	24/05/05	2.5	2.5	2.5	0.0	Repaying
DOEP (AMENDED)	Direct	05/05/99	54.7	17.5	17.5	0.0	Completed
Danfoss Debt Facility for Industrial Energy Projects	Regional fund investment	20/12/02	0.3	0.1	0.1	0.0	Completed
Dnipropetrovsk Municipal Water and Waste-Water Project	Direct	09/06/05	30.5	20.0	20.0	0.0	Disbursing
Dnipropetrovsk Oil Extraction Plant I(DOEP I)	Direct	28/07/95	15.3	6.3	6.3	0.0	Completed
Dnipropetrovsk Oil Extraction Plant II (DOEPII)	Direct	16/09/97	14.9	14.9	14.9	0.0	Completed
EFES - EBI	Regional fund investment	15/04/02	1.4	0.4	0.4	0.0	Completed
Ekoenergia(Alchevsk Iron&Steel Works Cogeneration Facility)	Direct	21/12/06	201.0	74.4	74.4	0.0	Signed
Emerging Europe Convergence Fund II	Regional fund investment	24/08/05	6.0	6.0	0.0	6.0	Repaying
Energy Alliance	Direct	19/02/04	2.2	1.1	1.1	0.0	Completed
Europolis 3	Regional fund investment	21/09/06	45.0	15.8	9.5	6.3	Disbursing
Europolis II	Regional fund investment	15/11/04	21.0	5.3	3.9	1.4	Disbursing
Euroventures Ukraine II	Direct	30/06/05	56.0	18.8	0.0	18.8	Disbursing
Eurovision - Ukraine	Direct	14/12/93	0.7	0.7	0.7	0.0	Completed
FUIB Credit Facility	Direct	11/08/95	9.7	9.7	9.7	0.0	Completed
Farmak	Direct	01/12/06	32.0	22.0	22.0	0.0	Disbursing
First Lease LLC (ALD Automotive Ukraine)	Direct	09/02/06	12.0	12.0	12.0	0.0	Repaying
Forum Bank: Syndicated Loan	Direct	13/03/07	26.8	8.9	8.9	0.0	Disbursing
GTC Ukraine Equity	Direct	18/10/06	74.5	7.4	0.0	7.4	Disbursing
Galnaftogaz	Direct	29/11/05	18.6	11.2	11.2	0.0	Disbursing
Golden Telecom	Regional fund investment	30/09/99	42.8	13.0	0.0	13.0	Repaying
ISTIL (Ukraine) II	Direct	09/12/04	33.5	22.3	22.3	0.0	Completed
ISTIL Restructuring	Direct	13/02/07	93.1	26.1	26.1	0.0	Disbursing
ISTIL-UKRAINE	Direct	15/11/01	96.7	18.6	18.6	0.0	Completed
ITUR	Direct	30/06/94	46.3	39.5	39.5	0.0	Completed
IVECO/Kraz Joint Venture	Direct	08/11/95	36.3	10.3	10.3	0.0	Completed
Integrated Agricultural Services and Processing	Direct	15/05/95	22.9	7.9	5.6	2.3	Completed
Iveco Ukraine	Direct	26/09/00	32.3	8.9	8.9	0.0	Completed
JSC Vetropack Gostomel Glass Factory	Direct	27/01/04	12.7	4.1	4.1	0.0	Completed
JSCB OTP Bank, Ukraine - Mortgage Credit Line	Direct	21/05/05	7.4	3.7	3.7	0.0	Repaying
K2R4 Post-start-up Safety and Modernisation Programme	Direct	29/07/04	93.1	31.3	31.3	0.0	Disbursing
Kiev International Bank	Direct	18/08/95	5.0	1.8	0.0	1.8	Completed
Kiev International Bank	Direct	21/10/99	0.8	0.8	0.0	0.8	Completed
Kreditprom SME credit line	Direct	26/12/05	7.4	7.4	7.4	0.0	Disbursing
Kreditprom Syndicated Facility	Direct	12/10/06	31.3	9.7	9.7	0.0	Disbursing
Kredo Bank Capital Increase	Direct	12/05/06	5.5	3.2	3.2	0.0	Disbursing
Kredo Bank Ukraina Mortgage Credit Line	Direct	22/12/05	7.4	7.4	7.4	0.0	Disbursing
Kredo Bank Ukraine - Multi Bank Equity	Direct	17/09/99	22.6	18.9	18.9	0.0	Repaying
Kronospan UA	Direct	01/11/06	100.0	35.0	35.0	0.0	Disbursing
Kvazar-Micro Corporation BV (KMC)	Direct	18/11/02	6.3	3.0	3.0	0.0	Completed

Lesaffre First Commitment	Regional fund investment	27/07/05	10.7	2.2	0.0	2.2	Signed
MBA Loan Project (guarantee)	Regional fund investment	06/03/95	0.6	0.4	0.4	0.0	Repaying
MBA Loan Project II (guarantee)	Regional fund investment	07/12/98	0.1	0.1	0.1	0.0	Signed
MTS Loan	Regional fund investment	08/12/04	355.5	58.4	58.4	0.0	Repaying
Malteurop	Direct	11/07/02	70.0	36.2	36.2	0.0	Repaying
Marbleton Property Fund	Regional fund investment	14/06/06	29.8	6.0	0.0	6.0	Signed
Mittal Steel Kryviy Rih	Direct	04/04/06	148.9	148.9	148.9	0.0	Disbursing
NIS Restructuring Facility	Regional fund investment	16/03/00	2.4	0.5	0.0	0.5	Repaying
Nidera (Ukraine)	Direct	01/04/03	3.0	3.0	3.0	0.0	Completed
OJSC Slavutich Brewery	Direct	21/11/01	41.8	12.7	12.7	0.0	Repaying
OJSC Vetropack Gostomel Glass Factory	Direct	25/03/02	12.7	10.5	10.5	0.0	Completed
ORCO APARTHOTELS	Regional fund investment	07/03/03	16.0	1.4	0.0	1.4	Completed
Obolon Brewery	Direct	10/12/97	46.9	22.3	22.3	0.0	Completed
Obolon Phase II	Direct	08/12/04	7.4	7.4	7.4	0.0	Completed
Odessa High Voltage Grid Upgrade	Direct	16/12/05	25.8	25.8	25.8	0.0	Disbursing
PPF - Euroventures Ukraine - Internatl. Distrib. System Ltd	Direct	20/12/00	2.1	2.1	0.0	2.1	Completed
PPF - Euroventures Ukraine - Anthousa Ltd (Furshet)	Direct	26/06/02	2.5	2.3	0.0	2.3	Repaying
PPF - Euroventures Ukraine - Hudson Asset Management	Direct	23/11/00	2.4	2.4	0.0	2.4	Disbursing
PPF - Euroventures Ukraine - Laona Investments (former Alba)	Direct	30/07/02	2.5	2.1	0.0	2.1	Disbursing
PPF - Euroventures Ukraine - Orleander	Direct	17/07/01	3.1	3.1	0.0	3.1	Disbursing
PPF - Euroventures Ukraine - P5 Communications	Direct	15/11/00	1.1	1.1	0.0	1.1	Completed
PPF - Euroventures Ukraine: Abikelly Ltd	Direct	18/03/05	1.8	1.8	0.0	1.8	Disbursing
PPF - Euroventures Ukraine: Sentera (former Cable Holding)	Direct	20/05/05	4.4	2.2	0.0	2.2	Disbursing
PPF - Euroventures Ukraine: Sodelem Dev. (for. Milky Land)	Direct	15/02/02	3.4	2.1	0.0	2.1	Disbursing
PPF - Euroventures Ukraine: Statinko Ltd.(former Frau Marta)	Direct	30/04/04	1.9	1.9	0.0	1.9	Disbursing
Poltava Oil and Gas Project	Direct	26/04/95	31.9	6.0	6.0	0.0	Completed
ProCredit Bank Ukraine - A/B Loan	Direct	20/12/06	20.1	6.7	6.7	0.0	Disbursing
ProCredit Bank Ukraine - Equity	Direct	16/06/06	2.3	2.3	0.0	2.3	Disbursing
Procter & Gamble Distribution	Direct	30/12/98	81.0	1.5	1.5	0.0	Completed
Radisson SAS Kyiv II	Direct	01/12/98	50.5	18.1	9.8	8.3	Repaying
Raiffeisen International	Regional fund investment	20/10/04	10.0	5.0	0.0	5.0	Repaying
Railway Development Project	Direct	06/12/99	70.8	38.6	38.6	0.0	Repaying
Regional TFP: Aval bank (Gtees & cash disb)	Direct	24/01/01	19.0	19.0	19.0	0.0	Signed
Regional TFP: Forum Bank	Direct	24/01/01	3.9	3.9	3.9	0.0	Signed
Regional TFP: Hypovereinsbank Ukraine (G. & Pre-export)	Direct	19/12/01	0.8	0.8	0.8	0.0	Disbursing
Regional TFP: JSCB OTP Bank, Ukraine	Direct	22/10/02	0.6	0.6	0.6	0.0	Disbursing
Regional TFP: Kreditprombank ( Guarantee & Pre-export)	Direct	20/10/04	19.3	19.3	19.3	0.0	Disbursing
Regional TFP: Kredo Bank Ukraina (former WUCB)	Direct	01/03/02	1.0	1.0	1.0	0.0	Disbursing
Rehabilitation of M06 H'way & Road Sector Financing Reform	Direct	11/12/00	99.2	74.2	74.2	0.0	Repaying
Renaissance Life Ukraine	Direct	14/07/06	4.2	1.4	0.0	1.4	Disbursing
Rubizhansky Cardboard and Packaging Mill	Direct	26/11/03	30.9	10.4	10.4	0.0	Repaying
SigmaBleyzer Southeast European Fund IV CV	Regional fund investment	23/12/05	37.5	37.5	0.0	37.5	Disbursing
Slavutich Expansion II	Direct	12/04/07	72.4	36.2	36.2	0.0	Disbursing

Slobozhanska Budivselna Keramika (SBK)	Direct	14/12/06	7.4	7.4	0.0	7.4	Disbursing
Soufflet ACL 2004 Slavuta	Direct	07/09/04	6.7	6.7	6.7	0.0	Disbursing
Soufflet Slavuta - Ukraine	Direct	21/10/04	35.8	8.8	8.8	0.0	Disbursing
Soufflet Ukraine ACL 05	Direct	11/08/05	5.2	5.2	5.2	0.0	Repaying
Starobeshevo Power Modernisation Project	Direct	11/12/96	110.4	96.4	96.4	0.0	Repaying
State International Airport Borispol	Direct	22/12/93	11.0	3.8	3.8	0.0	Completed
Subordinated Loan to JSCB OTP Bank, Ukraine	Direct	23/06/03	3.7	3.7	3.7	0.0	Disbursing
Svitoch Confectionery	Direct	22/04/97	3.9	3.1	3.1	0.0	Completed
Toepfer Ukraine W C New Facility 2005	Direct	20/07/05	180.5	134.0	134.0	0.0	Completed
Toepfer Working Capital Revolving Facility	Direct	14/06/02	89.3	35.7	35.7	0.0	Completed
Toepfer Working Capital Revolving Facility 2004	Direct	09/06/04	145.2	89.3	89.3	0.0	Completed
Toepfer Working Capital Revolving Facility/2003	Direct	03/06/03	135.3	59.4	59.4	0.0	Completed
UKEEP - Kreditprombank	Direct	15/12/06	7.4	7.4	7.4	0.0	Disbursing
UKEEP - State Export Import Bank of Ukraine (UkrExim)	Direct	25/04/07	18.6	18.6	18.6	0.0	Signed
UMLP II - Forum Bank	Direct	17/10/05	5.2	5.2	5.2	0.0	Disbursing
UMLP II - Kreditprombank	Direct	23/11/05	5.2	5.2	5.2	0.0	Disbursing
US/EBRD SME - ProCredit Bank Ukraine	Direct	02/10/00	33.4	8.7	6.7	2.0	Repaying
US/EBRD SME - ProCredit Bank Ukraine	Direct	14/11/03	9.1	3.8	3.0	0.9	Disbursing
UkrEsco II	Direct	21/10/05	7.4	7.4	7.4	0.0	Disbursing
Ukraine Energy Service Company - UkrEsco	Direct	09/05/98	20.7	14.7	14.7	0.0	Completed
Ukraine Ent. Facility - First Ukrainian International Bank	Direct	26/10/00	7.4	7.4	7.4	0.0	Completed
Ukraine Ent. Facility - Hypovereinsbank Ukraine	Direct	18/12/01	7.4	7.4	7.4	0.0	Completed
Ukraine Ent. Facility - JSCB OTP Bank, Ukraine	Direct	14/12/01	11.2	5.2	5.2	0.0	Repaying
Ukraine Fuel Purchase Loan Facility	Direct	06/10/00	43.9	43.9	43.9	0.0	Completed
Ukraine Fund	Direct	25/03/93	9.0	2.9	0.0	2.9	Completed
Ukraine Fund Capital Increase	Direct	13/12/95	8.2	2.6	0.0	2.6	Completed
Ukraine International Airlines	Direct	14/12/00	4.0	4.0	4.0	0.0	Disbursing
Ukraine Multi Bank Equity Finance - FUIB (Share Purchase)	Direct	29/12/98	4.9	4.9	0.0	4.9	Completed
Ukraine Railways: Fast Passenger Trains Project	Direct	31/08/04	107.6	59.6	59.6	0.0	Disbursing
Ukraine SME Credit Line II	Direct	08/05/98	69.4	65.7	65.7	0.0	Repaying
Ukraine SME Lending FW - Forum Bank	Direct	30/06/05	7.4	7.4	7.4	0.0	Repaying
Ukraine SME Lending FW - SEB Bank	Direct	02/06/05	7.4	7.4	7.4	0.0	Repaying
Ukraine SME Line of Credit	Direct	16/12/94	90.2	90.2	90.2	0.0	Completed
Ukraine Second Project "Kiev-Chop Road Rehabilitation"	Direct	28/02/05	138.0	100.0	100.0	0.0	Disbursing
Ukraine Subordinated Credit Facility to JSCB OTP Bank, Ukra	Direct	23/12/99	7.4	5.2	5.2	0.0	Disbursing
Ukraine Third Project "Kiev-Chop M06 Road Rehabilitation"	Direct	19/12/06	486.0	200.0	200.0	0.0	Signed
Ukraine/Aval/2003/Warehouse Receipt Programme	Direct	10/09/03	11.9	9.7	9.7	0.0	Completed
Ukraine/Aval/2004/Warehouse Receipt Programme	Direct	09/09/04	22.3	14.9	14.9	0.0	Completed
Ukraine/Aval/Warehouse Receipt Programme	Direct	13/11/02	7.4	7.4	7.4	0.0	Completed
Ukraine/UkrSotsBank/2003/Warehouse Receipt Programme	Direct	15/12/03	7.4	7.4	7.4	0.0	Completed
Ukrainian Wave (f.k.a L'viv Wireless)	Direct	10/12/97	20.8	5.2	5.2	0.0	Completed
Ukrrihflot	Direct	29/09/95	23.7	6.0	6.0	0.0	Completed
Ukrrihflot II	Direct	20/10/00	7.7	2.0	2.0	0.0	Completed

Ukrrichflot III	Direct	20/10/00	30.9	15.5	15.5	0.0	Repaying
Ukrrichflot III - Follow On Loan	Direct	04/11/05	37.2	9.7	9.7	0.0	Repaying
Uksnab	Direct	26/04/06	12.4	6.2	0.0	6.2	Disbursing
Vetropack Gostomel	Direct	07/08/06	43.9	22.0	22.0	0.0	Repaying
Zaporizhzhia - Water Utility Development & Investment Progr.	Direct	21/05/99	32.4	20.8	20.8	0.0	Repaying
Zitomir - Yioula Glassworks S.A.	Direct	20/10/06	10.0	4.0	4.0	0.0	Disbursing
			<b>5,812.8</b>	<b>2,902.3</b>	<b>2,662.8</b>	<b>239.5</b>	

**EBRD Project Pipeline, 30 June 2007(in €million)**

<b>Operation Name</b>	<b>Public/Private Sector</b>	<b>Loan/Equity</b>	<b>EBRD Financing (EURO MM)</b>
<b>INFRASTRUCTURE</b>			
Ukraine Railways: Fast Passenger Train Project	Public	Loan	29.8
Ukraine Railways: Rolling Stock Renewal	Public	Loan	186.1
Illichivsk Commercial Port Infrastructure	Public	Loan	26.0
Kiev City Transport	Public	Loan	120.0
Odessa District Heating	Public	Loan	20.0
Vinnitsia District Heating	Public	Loan	10.0
Five other projects	Public/Private	Loan/ Equity	33.7 4.7
<b>Total:</b>			<b>430.3</b>
<b>POWER AND ENERGY</b>			
Rivne Kiev High Voltage Line	Public	Loan	150.0
Kaniv Hydro Pump Storage Facility	Public	Loan	250.0
Krymenergo	Public	Loan	111.7
Gas Distribution Energy Efficiency Loan	Public	Loan	18.0
<b>Total:</b>			<b>529.7</b>
<b>NATURAL RESOURCES</b>			
Three Projects	Public/Private	Loan	97.1
<b>Total:</b>			<b>97.1</b>
<b>SPECIALIZED INDUSTRIES</b>			
10 Projects	Private/Public	Loan	253.1
<b>Total:</b>			<b>253.1</b>
<b>GENERAL INDUSTRIES</b>			
Four Projects	Private	Loan	126.9
<b>Total:</b>			<b>126.9</b>
<b>FINANCIAL INSTITUTIONS</b>			
15 Projects	Private	Loan/ Equity	264.8 35.6
<b>Total:</b>			<b>300.4</b>
<b>Grand Total:</b>			<b><u>1737.5</u></b>

## **Canada**

In keeping with past achievements, the CIDA Ukraine Program is currently elaborating a new Country Development Programming Framework (2007-2011) that will continue to support the successful integration of Ukraine into the global market economy and the peaceful development of a democratic system of government driven by rule of law. Democratic Governance will be the main focus helping build: accountable public institutions, rule of law, the capacity of regional and local governments to provide responsible, fair and equitable services, and the capacity of civil society to engage with government. In terms of private sector development, emphasis will be placed on agriculture and rural development.

The Program will continue to promote linkages between Canadian and Ukrainian NGOs and build partnerships with other Canadian government departments that have broader interests in Ukraine. In accordance with the Paris Declaration on Aid Effectiveness, efforts will also focus on enhancing the capacity of the Government of Ukraine to identify its development priorities, strengthen local ownership and improve donor coordination. New trilateral cooperation initiatives with Central European countries will be explored to leverage third country sources of funding and expertise to assist Ukraine.

Working in partnership with EBRD, CIDA is currently contributing to institution building of the local banks of Ukraine by providing training and expert advice which will develop their long-term capability to provide households with access to mortgage financing. In addition, there are approximately 20 operational projects dispersed across Ukraine mostly in the area of governance. Projects that will be implemented in 2007 include the *Policy Reform and Implementation Support Mechanism* and the *Civil Service Reform Project*, which aims to support Ukraine's efforts in developing an accountable and transparent civil service that is in line with European norms. The *Juvenile Justice Reform Project*, dealing with issues regarding how best to provide an integrated set of appropriate services, rehabilitation and support to youth at risk, and the *Combating Corruption Project* the goal of which is to strengthen the capacity of key government organizations to design and deliver more effective legislation, are also scheduled to start during this period.

## **France**

The Ministry of Economy, Finance and Industry has supported the Ukraine through its bilateral grant facility (FASEP) and through its Technical Cooperation fund at EBRD: technical assistance has been committed to the Municipality of Dnipropetrovs'k (water supply, 500 000 €), to the Municipality of Lviv (heating system, 500 000 €) and to the Ukrainian Railways (feasibility study of high speed railway links between Kiev and Lviv and Kiev and Odessa, 600 000 €).

ADETEF (Assistance for the Development of Exchanges in Economic and Financial Technologies, a body tasked with implementing the technical cooperation of the Ministry of the Economy, Finance and Industry) is leading two projects financed by the European Union to support the reorganization of the Ukrainian Treasury and of the

Ukrainian Office of Statistics.

ADETEF has also committed an amount of 63 000 € in 2005 and an amount of 163 000 € in 2006 to provide technical assistance in the fields of consumer protection, competition, statistics and the fight against fraud and counterfeit goods.

The Ministry of Foreign Affairs has allocated 786 000 € for TA in 5 priority areas :

- Legal cooperation (nomination of a technical assistant at the Ukrainian Ministry of Justice, support of reforms in justice, of training of lawyers, of the reinforcement of the judges' s independence, set-up of administrative jurisdictions and reinforcing the legal expertise capacity of the ministry of justice);
  - Fight against clandestine immigration, organised crime, narcotics and money laundering by organising training programmes and exchanges;
  - Civil service and administration (support of the reform of the administration and nomination of a technical assistant at the Ukrainian Civil Service)
  - Agribusiness sector (improve the cooperation with the business organisations and the ministry of agriculture, nomination of a technical assistant at the Ukrainian ministry of agriculture)
  - Healthcare (prevention, training and information programmes).
- France is one of the main contributors to the two funds set up by the G7 and managed by the EBRD to improve nuclear safety at the Chernobyl site.

## **Germany**

For the period 2002 – 2006 Germany has provided development assistance to Ukraine for a total of 65,5 million Euro. Out of this total amount, 51.5 million Euro were provided for financial assistance and 14 million Euro for technical cooperation.

Further amounts allocated for 2007: Total commitments of 22 million Euro, out of which 6 million Euro for financial assistance and 16 million Euro for technical cooperation.

## **Italy**

The Ministry of Foreign Affairs and the Ministry of Economic Development provided TA in different sectors, with a particular focus on SMEs, infrastructure, environmental protection, enhancement of democracy and fight against clandestine immigration. During the period 2002-2007, through bilateral cooperation facilities for eastern Europe transition countries (l. 212/1992) and for peace and humanitarian initiatives (l. 180/1992) TA was funded for a total of over EUR 600,000. In 2004 Italy provided a contribution of EUR 500,000 to UNDP for an emergency program against HIV in the region of Odessa. In the field of the protection of minors, the Italian MFA Directorate General for International Cooperation funded a EUR 500,000 project within the "Action Programme against Trafficking in Minors for Sexual Purposes", implemented by UNICRI in close cooperation with ECPAT International, aimed at reducing trafficking in minors for sexual exploitation and serious violations of children's fundamental rights

linked with this phenomenon. The project in Ukraine lasted 20 months, till August 2006.

At a more decentralised level and in close cooperation with the Ukrainian Ministry of family, sport and youth, several projects concerning abandoned youth are carried out by Italian regional and/or municipal authorities. The relevant projects are monitored by the competent Italian and Ukrainian central authorities. Under the 2003-2006 three-years executive program of the bilateral agreement in the field of cultural and scientific cooperation, Italy provided a contribution of EUR 150,000.

Within the G7 group, Italy is one of the main contributors to the funds managed by EBRD to deal with the long-term impact of the Chernobyl incident and improve safety at the site.

The Italian Government is supporting Ukraine in implementing the objectives and the priorities set by the European Union Neighborhood Action Plan, through the new 500 million Euro financial facility envisaged for this purpose. In this framework, the Italian regulatory Authority for electricity and gas has been awarded the first twinning program ever launched in Ukraine. The joint activity between the Italian Authority and the National Electricity Regulatory Commission of Ukraine has started in June 2007. Other Italian institutions and companies are active under the European Tacis instrument in several other sectors, including energy and agriculture. Italy is working closely with other major donors and the Ukrainian governmental authorities in meeting the goals of the Paris declaration on donor harmonization and aid effectiveness.

## **Japan**

Japanese bilateral assistance to the Ukraine began in 1992 and through 90s its main focus was (1) nuclear safety and related subjects including nuclear safety and disaster relief in response to the Chornobyl nuclear accident (approx. 95million of grants and technical cooperation) and cooperation on the elimination of nuclear weapons (USD 19 million); and (2) financial support in the form of loans and export credits totalling USD 200 million from the former Japan Ex-Im Bank.

As for ODA, which started in 1997, Japanese assistance to the Ukraine has focused on supporting its economy's regional integration with a first yen loan for the expansion of Kiev's Borispil Airport, signed in March 2005 and worth JPY 19.1 billion .

Grant Aid has been extended to support the health sector in response to the victims of the Chornobyl nuclear accident, including a grant signed in 2006 for the rehabilitation of medical facilities for children. Cummulative grant Aid to date has totalled approximately USD 18 million. Japan also supported a community enhancement programme in the accident area through contributions to an UN agency.

Besides various nuclear safety and related subjects, Japan also extends Technical Assistance programmes focused on reforming the economy in such areas as improvement of productivity and modernization of coal mining technologies.

## **Sweden**

The overall strategic goal for Sweden's development cooperation with Ukraine is to help Ukraine in creating conditions that enable poor people to improve their lives, and in integration the country with the European Union. The strategy establishes that the best way for Ukraine to reach these goals would be to carry out an ambitious programme of economic and administrative reforms.

The Country strategy with Ukraine 2005-2008 includes possibilities to support reforms in six areas. These are Deepening of Democracy, Economic transition, Social sector, Environment, Common Security and Cooperation with Civil Society.

Within the area for Deepening of Democracy, efforts will aim at reinforcing the principle of rule of law and basic European values. Support to the SME is a priority within the area for Economic transition and modernization of the social assistance system, within the Social sector. As regards environmental cooperation, focus will be on water and wastewater management project in Lvov and energy efficiency. Common security cooperation is expected to be concentrated on migration and institutional development of the Ministry of Emergencies. Cooperation with civil society is targeting local authorities in Ukraine as well as social or environmental matters.

The annual budget for bilateral cooperation with Ukraine, which amounted to 102 Million SEK in 2006, is expected to increase to 150 Million SEK, towards the end of the strategy period.

## **United Kingdom**

The UK's Department for International Development (DFID) is in the process of ending its bilateral assistance to Ukraine by the end of March 2008. For the period April 2007 to March 2008 it will provide up to £3m for development activities. These will include: continued support for two wide ranging regional projects in Lviv Oblast and the Donbass (Donetsk and Luhansk Oblasts), covering a broad spectrum of assistance for economic and social development initiatives in these regions; assisting the Ukrainian government to develop its trade policies and finalise arrangements for WTO accession; supporting reforms in the delivery of, and development of appropriate policies for, social services, by working with the Ministry of Labour and Social Policy and pilot communities in Kharkiv and Khmelnytskyi Oblasts; creating a more open and transparent society by working with local community groups and authorities in pilot rayons/towns/cities in Lviv and Donetsk Oblasts; developing the private sector by improving the climate for investment and businesses by piloting a benchmarking index and cluster system in Kharkiv, Odessa and Zhytomyr Oblasts and working closely with the State Committee of Ukraine for Regulatory Policy and Entrepreneurship; providing support to UNAIDS to take forward the HIV/AIDS '3 Ones' principles in Ukraine to make more effective the co-ordination and monitoring of assistance provided by government and others to tackle HIV/AIDS.

DFID will use the period of its closure to ensure that lessons learned from its many projects and programmes are not lost. It will be organising a number of final project

events over the period June 2007 to February 2008, to ensure experiences are shared and disseminated to a wider audience. It will also be working closely with other donors, and play a leading role in supporting the Ukrainian government's plans to pursue the Paris Declaration agenda on donor harmonisation and aid effectiveness.

As part of UK Government, DFID will support Ukraine's implementation of its European Neighbourhood Partnership (ENP) Action Plan. The Action Plan sets out a comprehensive set of priorities covering Ukraine's ambitions for greater economic integration and closer co-operation with the EU.

From 2007 the European Neighbourhood and Partnership Instrument (ENPI) is the main EC financial instrument for supporting implementation of ENP Action Plan priorities. Ukraine will receive almost €500 million of ENPI assistance over the period 2007-2010. The three priority areas for assistance are: *Support for Democratic Development and Good Governance; Support for Regulatory Reform and Administrative Capacity Building and; Support for Infrastructure Development*

DFID will work with the EU institutions, and other stakeholders, to help ensure that the EU's relationship with Ukraine, and the assistance that the EC provides, are as effective as possible. UK interests in Ukraine will also continue to be represented through the projects the British Embassy supports through the Global Opportunities Fund and other initiatives, plus continuing to support British companies to invest and expand markets in Ukraine. The British Council will continue to provide support for Ukraine's reform agendas in education and closer integration with Europe.

## **United States**

Ukraine received U.S. assistance totalling more than USD 3.58 billion from 1992-2006, with over USD 94.5 million budgeted for 2007. In addition, the U.S. Millennium Challenge Account will provide approximately \$45 million over a two-year period to a Ukrainian MCA Threshold Program to combat corruption. U.S. assistance enhances regional security and non-proliferation; strengthens democratic governance, rule of law and civil society; promotes market-based economic reform; and supports health, social services and humanitarian assistance. The United States is meeting its commitment to contribute \$203 million by FY 2009 to the construction of a shelter over the Chernobyl nuclear reactor sarcophagus. By the end of 2006, the United States had provided \$153 million toward its Chernobyl commitment and budgeted \$20 million of 2007 funding.

Specifically, U.S. assistance to promote peace and security supports force modernization and reform, law enforcement reform, nuclear safety, border security, controlling weapons proliferation and combating transnational crime. To consolidate democratic progress and strengthen rule of law, U.S. assistance focuses on justice system reform, combating corruption, building the capacity of civil society and independent media; and strengthening political process and parties. U.S. economic assistance focuses on reform in the trade and investment, business, financial, energy and agricultural sectors. The U.S. also focuses assistance on combating HIV/AIDS and TB, promoting healthcare and family planning, and supporting job training, social services and humanitarian assistance for vulnerable populations.

