DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR UKRAINE

2011 - 2014

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LIST OF ABBREVIATIONS

AAU	Assigned Amount Units
the Bank	European Bank for Reconstruction and Development
BAS	Business Advisory Services
CSF	Chernobyl Shelter Fund
CTF	Clean Technology Fund
DIF	Direct Investment Facility
DLF	Direct Lending Facility
EaP	Eastern Partnership (of the EU)
E5P	Eastern Europe Energy Efficiency and Environmental Partnership
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
ENP	European Neighbourhood Policy
ESSF	EBRD Shareholder Special Fund
EU	European Union
EUR	Euro
E&S	Environmental and Social
FDI	Foreign Direct Investment
FI	Financial Institutions
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GMO	Genetically Modified Organism
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
IPO	Initial Public Offering
MFA	Macro-Financial Assistance
MEI	Municipal and Environmental Infrastructure
MSME	Micro, Small and Medium Enterprises
NAER	National Agency for Energy Efficiency
NERC	National Electricity Regulatory Committee
NIF	Neighbourhood Investment Facility
NBU	National Bank of Ukraine
NPL	Non-Performing Loan
NPP	Nuclear Power Plant
NSC	New Safe Confinement
OSCE	Organisation for Security and Cooperation in Europe
PPP	Public-Private Partnership
SEAP	Sustainable Energy Action Plan
SIP	Shelter Implementation Plan (of the Chernobyl NPP)
SME	Small and Medium Enterprise
TAM	Turn Around Management
TC	Technical Cooperation
TFP	Trade Facilitation Programme
USD	US Dollar
USAID	United States Agency for International Development
USELF	Ukraine Sustainable Energy Lending Facility
VAT	Value Added Tax

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, although application of these principles during the previous Strategy period has been somewhat uneven.

The past three years have been challenging for Ukraine. Despite having made significant progress in democratic reform following the Orange Revolution in 2004, the absence of political consensus within the Orange coalition, and between the government and the strong political opposition, led to a period of instability and political deadlock. Profound disagreements between the executive and legislative branches resulted in the stalling of reforms, particularly in the vital areas of public governance and combating corruption.

The presidential elections held in early 2010 were deemed by international observers to have been free and fair. However, steps taken since the election have the potential to impact the constitutional checks and balances in the political system. The challenge for the new president and government now is to maintain the democratic gains of the past five years while ensuring political stability, strengthening the accountability of public policymaking and combating corruption.

Ukraine is one of the countries most affected by the recent financial crisis. Its key pre-crisis vulnerabilities included dependence on commodity exports (in particular, steel), high foreign currency refinancing requirements of the private sector, dependence on subsidised gas imports from Russia and the lack of effective policy coordination mechanisms. The collapse of demand for, and price of, steel at the end of 2008, together with a rise in gas import prices significantly reduced the contribution of net exports to growth. At the same time, domestic demand suffered from the reversal of external capital inflows and the impact of the crisis on company balance sheets was compounded by the instability in the banking sector, the severe contraction of lending by banks and the accumulation of large VAT refund arrears by the government. As a result, overall output contracted by 14.8 per cent in 2009 and FDI fell. The public sector balance sheet deteriorated as the authorities utilised fiscal policy to cushion the impact of the crisis.

The economic situation improved in 2010 following the February elections. The new government has responded to the crisis by implementing fiscal, financial sector and some structural reforms. In May 2010, the new government unveiled an ambitious medium-term reform programme, which encompasses a wide range of strategic initiatives aimed at creating preconditions for economic growth. Investor confidence has improved somewhat, especially after the authorities reached agreement with the IMF on a new medium-term arrangement in July 2010 but appears to have since lost some of this positive momentum. Yields on public sector debt have fallen, the stock market has recovered and the National Bank of Ukraine (NBU) has been able to replenish foreign exchange reserves.

The post-crisis recovery is expected to be protracted due to weak domestic demand, ongoing adjustment to the terms of trade shock, lingering problems in the financial sector, the limited capacity of government to provide further fiscal stimulus to attract inward investment. The announced structural reforms, if implemented fairly, should contribute towards increasing the country's long-term growth potential and help mitigate the post-crisis macroeconomic vulnerabilities.

Challenges

The key immediate challenge for the authorities is to put the public sector debt onto a sustainable path and complete post-crisis stabilisation of the financial sector. Measures in this area are being implemented with the support of the IMF and other international institutions. In addition, it will be necessary to significantly improve the business environment and reduce the perceptions of endemic corruption in order to attract large scale quality investments that would, over time, help to reduce Ukraine's dependence on several low value added and energy intensive export sectors.

Ukraine continues to face important transition challenges in all key sectors, which include:

- **Strengthening energy efficiency and energy security.** Ukraine is a major net importer of oil and gas, and an important transit country. At the same time, its economy remains one of the most energy-intensive and inefficient in the region. The energy sector has suffered from years of serving primarily quasi-fiscal or political, rather than commercial, objectives. Ukraine's accession to the Energy Community with the EU and the decision to raise domestic gas prices to import parity over time is expected to strengthen the gas and electricity sectors, create conditions for greater energy efficiency and conservation and support Ukraine's ambition to remain an energy transit country. Improving governance and transparency in the sector, as well as commercialisation and unbundling of NAK Naftogaz, will be needed to strengthen its ability to raise additional finance to modernise the gas transit system and develop its natural resource base.

- **Unlocking Ukraine's agricultural and industrial potential.** Ukraine carries great potential in the agricultural sector and is capable to help address global food security challenges over time. However, its potential has been only partly realised as sector productivity remains low, access to finance limited, and the future of land ownership and user rights uncertain. The industrial sector is expected to benefit from Ukraine's recent accession to the WTO and the deep and comprehensive free trade area under negotiations with the EU. The sector has, however, suffered during the crisis from reliance on short-term finance, terms-of-trade shocks, and reduced international demand. Close links between business and politics, weak governance and transparency, and poor enforcement of competition policies hamper industrial development and inward investment. Recent government intervention and the imposition of grain export restrictions have had a negative effect on grain producers.

- **Providing good quality and reliable infrastructure.** Recent years witnessed some improvement of the transport and municipal infrastructure, which suffered during Ukraine's prolonged transition recession. As the state's ability to allocate significant investment resources to this sector will be limited after the crisis, it will be important to engage the private sector in the rehabilitation and maintenance of roads and seaports, and encourage competition in the rail and aviation sectors. Although the municipal utilities are decentralised, they have suffered from the politicisation of tariff setting, governance problems and from restrictions in their ability to finance commercially viable projects.

- **Dealing with the legacy of the crisis in the financial sector.** Ukraine's highly dollarised financial sector continues to suffer from post-crisis de-leveraging, reliance on short-term funding as well as the long-standing governance problems. The role of the state in the sector has increased during the crisis as state owned institutions received significant capital injections and several banks were nationalised. State ownership may reduce the sector's long-term efficiency and, ultimately, hamper economic growth potential. The international banks supported their Ukrainian subsidiaries during the crisis, however, their future in Ukraine will depend to a large extent on whether the authorities adopt supervisory methods in line with international best practices, establish effective coordination with home supervisors and fair competition. The non-banking sector is in the nascent stages of development and local currency capital markets remain largely underdeveloped.

The Bank's strategic directions

During the post-crisis economic recovery the Bank will focus on addressing the key transition challenges in line with the government's reform programme, in close coordination with other International Financial Institutions (IFIs) and bilateral donors:

- ***Energy.*** The Bank will support safety upgrades in the nuclear sector, electricity transmission networks, operations that would integrate Ukraine into the European energy market and operations that will increase the overall energy efficiency and decrease the carbon intensity of the sector. The Bank will also support the modernisation of Ukraine's gas transportation and distribution system, provided the authorities pursue a comprehensive and credible reform agenda, including restructuring of NAK Naftogaz.

- ***Enterprises.*** The Bank will support FDI and local enterprises to help diversify the economy and restructure old energy-intensive industries with a focus on improving their governance, transparency and energy efficiency. In recognition of Ukraine's great potential as an agricultural producer, the Bank will support investments along the whole value chain and especially the instruments that support primary producers, including seasonal working capital. The Bank will assist Ukraine in the development of knowledge intensive industries and effective use of its human and scientific potential, as well as support the government's privatisation programme of remaining state enterprises, promoting the transparency of the process in order to maximise value for the public sector.

- ***Infrastructure.*** In the road sector, the Bank will support the completion of the modernisation of the main transport corridor connecting the country to the European

Union. The railway sector, which suffered from the emergence of major bottlenecks before the crisis-related recession, can be supported only after the authorities make credible steps to corporatise the national rail operator and permit entry of private

operators. The Bank will also support commercialisation of municipal utilities through projects with large demonstration effects or energy efficiency gains.

- ***Financial Sector and Capital Markets.*** Main priorities will include providing the banking sector with targeted long-term loan and equity funding together with technical assistance to help support activities that will help to limit the sector's future instability, including strengthening governance, diversifying long-term funding sources and supporting local currency lending to the extent possible. The lending instruments would focus on MSMEs, financing energy efficiency improvements and trade facilitation, with the use of appropriate technical assistance. In cooperation with other IFIs, the Bank will help the authorities strengthen the role of private capital in the banking sector. The Bank will work with other IFIs and the NBU to address remaining issues preventing the Bank from structuring loans in local currency.

The success of the Bank's ambitious operational strategy in Ukraine will to a large extent depend on implementation of reforms in all main sectors. Slow reform progress will inevitably lead to reduced investment by the Bank, particularly in the public sector. In the coming years, the Bank will be actively involved in policy dialogue with the authorities together with other IFIs. The recent experience of coordinating discussions in the gas and financial sectors sets a good precedent which the Bank will seek to emulate in other sectors.

1. BANK'S OPERATIONS TO DATE AND CURRENT PORTFOLIO

1.1 OVERVIEW OF ACTIVITIES TO-DATE

Ukraine is the Bank's second largest country of operations. From 1992 to the end of 2010, the Bank signed over 280 projects in Ukraine accounting for a net cumulative business volume of over EUR 5.9 billion.

Table 1: EBRD's Portfolio in Ukraine as of 31st December 2010

Amounts in EUR millions

Sector		Undrawn Commitments	Drawn Commitments (Operating Assets)	Total Portfolio
Energy	Private	24	79	102
	State	328	45	372
Financial Institutions	Private	106	997	1,103
	State	0	0	0
Corporate	Private	210	841	1,050
	State	8	5	13
Infrastructure	Private	54	30	84
	State	628	313	941
Equity Funds	Private	69	80	149
	State	0	0	0
Total	Private	462	2,025	2,488
	State	963	363	1,326
Grand Total		**1,426**	**2,388**	**3,813**

The current private / public debt ratio (as a percentage of the total portfolio) is approximately 65 / 35 which is in line with the Bank's 60 / 40 mandated ratio.

1.2 IMPLEMENTATION OF THE PREVIOUS COUNTRY STRATEGY

The Bank's strategy approved in September 2007 set the following priorities:

- Promote higher efficiency, competitiveness and diversification of the economy;
- Improve corporate governance standards in the local private sector and assist FDI;
- Promote the development of the capital markets and provide continued support to MSME through dedicated long-term credit lines with partner banks;
- Promote energy efficiency and security, environmental protection and sustainable use of natural resources throughout all sectors of the economy;
- Improve the efficiency and reliability of key infrastructure, power generation, transmission and distribution, municipal infrastructure and of the oil and gas transport systems; but also

improve the nuclear safety standards, as well as prepare for decommissioning of Chernobyl NPP and the creation of a New Safe Confinement (NSC) for its Unit 4.

The Bank was well under way to delivering on its strategy up until the last quarter of 2008, meeting transition targets and having substantially increased investments with high energy efficiency impact. The energy efficiency component in the Bank's transactions more than doubled from EUR 163 million in 2007 to EUR 348 million in 2008. However, the onset of the financial crisis prevented further significant investment and the investment in energy efficiency reduced to EUR 139 million in 2009.

In May 2008, the Bank successfully held its annual meeting in Kyiv that raised the profile of Ukraine, but also the awareness of EBRD activities in both political circles and in the business community, and the importance of the Bank's engagement in the reform process in Ukraine.

At the end of 2008, Ukraine experienced the unprecedented impact of the global financial crisis. The enterprise sector was severely affected through the devaluation of the Hryvnia, cessation of bank funding, significant reduction in FDI, and liquidity constraints imposed by the Government's inability to refund VAT in a timely manner.

In response to the crisis, the Bank quickly adjusted its focus to provide an extensive country specific crisis response programme that focused on the banking sector that had expanded rapidly in 2007-2008, but suffered badly from the combined effect of weak internal governance and controls, large scale foreign currency lending to un-hedged borrowers as well as a poor institutional and regulatory environment. In coordination with strategic investors and regulators, the Bank invested over EUR 1 billion in the financial sector in 2008-2009, including over EUR 600 million to support the capital base of banks. The extent and speed at which the Bank engaged in a difficult period, was considered a significant success that helped to save the Ukrainian banking sector from a systemic crisis, complementing support from other IFIs.

In the area of domestic capital market development and associated long-term credit lines provided to banks, the EBRD has achieved limited success, due to the lack of a macro prudential focus on the importance of limiting dollarisation and stimulating domestic savings. Moreover, the Bank, along with other IFIs, has long been attempting to secure the necessary regulatory permissions (including those from the NBU) to raise, manage and lend local currency. To date, regretfully, this has not been achieved.

The Bank met its strategic goals related to improving nuclear safety at operating nuclear power plants (NPPs) and to facilitate the donor funded activities necessary to convert Chernobyl into a safe state - including the creation of a NSC for Unit 4 which was destroyed in the 1986 accident. In February 2009 the Bank made its largest ever grant to a single project (EUR 135 million). Design for the Chernobyl spent fuel storage facility (ISF-2) was completed in the summer of 2010. The Shelter Implementation Plan (SIP), financed from the Chernobyl Shelter Fund (CSF) in order to develop and implement a technical solution to transform the shelter around the destroyed Unit 4 into a safe state, made important progress. The NSC construction site and its infrastructure are largely completed. Most of the other donor funded Chernobyl projects, including the crucially important stabilisation of the shelter finalised in 2008, have either been completed or are nearing completion. The K2R4 project, safety upgrade of Khmelnitsky 2 and Rovno 4 nuclear power units to internationally accepted standards, was completed in 2010. The K2R4 projects set a new benchmark for nuclear safety and successful project implementation in Ukraine.

During the strategy period, the Bank significantly increased investment in Ukraine, from EUR 650 million in 2007 to approximately EUR 1 billion in both 2009 and 2010, investing about EUR 3.2 billion during the strategy period of September 2007 to end-2010. The Bank supported Ukraine's financial sector with over EUR 1.3 billion of investment, providing further EUR 900 million to the enterprise sector; nearly EUR 1 billion to address necessary modernisation and reliability of the key energy, transport and municipal infrastructure. However, one disappointing aspect has been the low level of disbursement of committed funding to the municipal sector, due to the difficulties associated with the approval and issuance of the municipal guarantees.

The Bank's portfolio grew from less than EUR 2 billion from the end of 2007 to over EUR 3.8 billion by the end of 2010. More importantly, the portion of equity and quasi-equity investments in the Bank's portfolio increased four-fold, from EUR 242 million to over EUR 1 billion, increasing from 12 per cent to 28 per cent of the total EBRD portfolio in Ukraine and clearly demonstrates the Bank's capacity to take higher risks during the crisis.

Table 2 below highlights the growth of the Bank's annual investment in Ukraine between 2007 and 2010. This performance should be viewed in the context of the financial crisis, the lack of meaningful reforms and the ongoing political and economic instability – all of which badly affected the Ukrainian economy and negatively impacted the confidence and growth aspirations of both domestic and international investors.

Table 2: Portfolio Trends: 2007 – 2010

Amount in EUR million	**2007**	**2008**	**2009**	**2010**
Net Cumulative Business Volume	3,241	4,087	4,760	6,435
Number of Operations	198	213	241	264
Current Portfolio Stock	1,954	2,569	3,109	3,813
Number of Operations	121	139	153	161
Operating Assets	972	1,508	2,137	2,390
% Undrawn	50%	41%	31%	37%
Annual Business Volume	650	835	1,013	964
Number of Operations	54	40	49	32
Gross Disbursements	491	702	838	441
Annual Cancellations	56	25	180	47
Active Pipeline Stock	1,670	1,598	2,205	1,998
Private Sector Share (% Portfolio)	66%	67%	70%	65%
Non Sovereign (% Portfolio)	69%	72%	76%	72%

EBRD's portfolio in Ukraine has not been immune to the effects of the financial crisis. No sector has been spared and a significant number of the Bank's clients have experienced financial stress and many have had to implement measures to adjust their business plans and to reduce their debt burden. That said, the level of non-performing loans in the Bank's portfolio remains small and is concentrated within a small number of clients. This performance is a testimony to the Bank's strong focus on client selection, the high level of due diligence undertaken, and the application of appropriate financing structures. It is also a result of a significant crisis response activity and the high quality of portfolio management. Significant challenges however remain as commercial bank lending remains scarce and de-leveraging continues.

Following the formation of the new government in March 2010, the focus has been on assisting the new authorities to deliver crucial reforms in infrastructure and energy in close cooperation with other IFIs. Within a short period of time, the Bank managed to agree key criteria with the authorities for further reforms in the power sector, some sub-sectors in transport (road and fuel taxes), and in gas, the latter having been conducted in close cooperation with the EU and other IFIs.

In April 2010, the Bank consolidated its locally based resources in a larger, new office in Kyiv, closing a small regional office in Dnipropetrovsk that had been in operation for 3 years. The impetus behind this decision was to focus the Bank's efforts where there was already a critical mass and thereby optimising costs and better serving the needs of Ukraine.

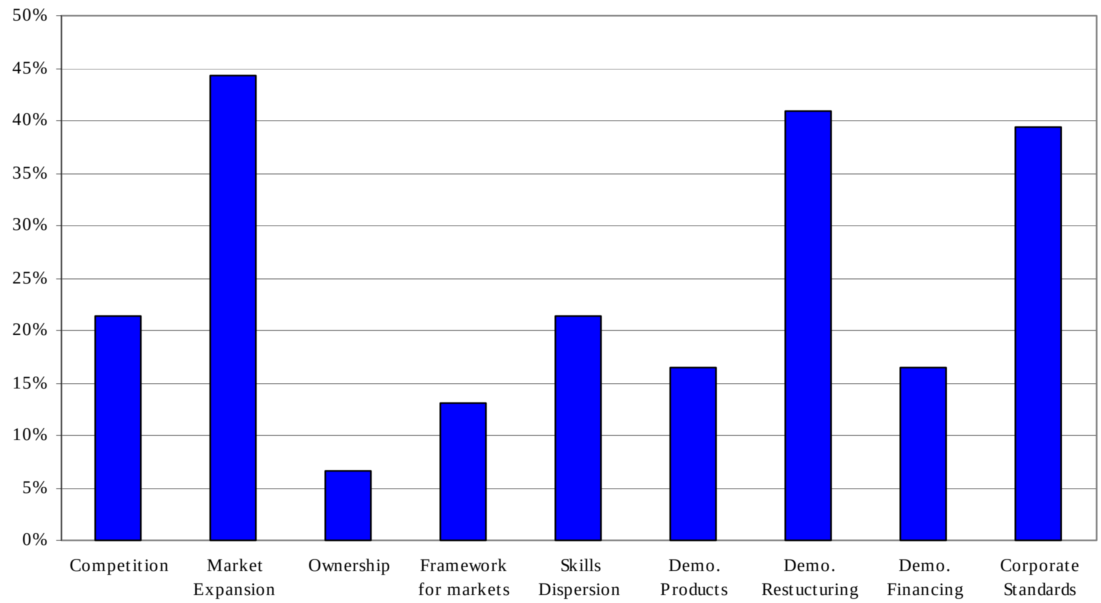
1.3 TRANSITION IMPACT OF THE BANK'S PORTFOLIO [1]

Since September 2007, 5 per cent of the Bank's projects in Ukraine were ex-ante rated "Excellent" and 87 per cent were rated "Good". This is above the institution-wide target of 80 per cent of projects to be rated "Good" or "Excellent." Only 5 projects were rated "Satisfactory," most of them during the pre-crisis period. As the crisis hit the region and the Bank's additionality increased, so did the transition impact potential of new projects. Transition impact potential of the portfolio deteriorated slightly during the crisis, especially for older projects, but this trend has balanced out recently with downgrades and upgrades remaining at par.

As Figure 1 indicates, key transition objectives across projects have been the building up of markets; restructuring; improving corporate governance and competition, as well as promoting skills dispersion.

[1] See Annex 5 for key lessons learned from previous strategy period.

Figure 1: Percentage of projects pursuing given transition objectives, 2005 - 2010



During the crisis period of 2008-2009, the Bank's policy dialogue in Ukraine focused on the stabilisation of the financial sector. The Bank engaged in policy dialogue with the NBU and other partner IFIs on the regulatory response to the financial crisis and co-organized round table discussions with the authorities, representatives of the leading foreign banks represented in Ukraine and IFIs with a view to ensuring continued commitment of the bank groups to their Ukrainian subsidiaries. The Bank also offered technical assistance to a large group of medium sized banks to ensure they would comply with the requirement to undertake their balance sheet diagnostics.

More recently, the Bank's main policy dialogue has involved discussions of (i) the authorities' plans to modernise the gas sector and restructure Naftogaz (in coordination with the EC and other IFIs); (ii) food security, including improved implementation of the warehouse receipts system, including best practices cereal balance forecasts; improved EU-Ukraine grain trade and sustainable grain production methods; (iii) policies to improve management of the road network and increase fuel taxation in line with the international practices; (iv) best practices on fiscal decentralization and debt management by the local authorities with the view to enabling commercially oriented municipal projects; (v) policies needed to develop capital markets, reduce dollarisation and other issues related to the Bank's potential hryvnia lending operations; (vi) challenges in the area of public sector governance facing Ukraine's corporate and financial sectors.

The enactment of the new Law on public procurement in line with best international standards and EU directives, as well as the development and enactment of the new Gas Law will establish the legal basis for regulatory harmonization with the EU and Ukraine's participation in the Energy Community Treaty. The measures requested by the EC and IFIs as pre-conditions for engagement in the sector include, among others, tariff increases to cost-recovery level (with protections for the poor), elimination of cross-subsidies and false price signals with respect to energy efficiency investment, improved metering and collection rates and the elaboration of a plan to restructure and legally un-bundle Naftogaz. The Bank is also coordinating a feasibility study for the modernisation of Ukraine's gas transit corridors and underground gas storage facilities which is funded by EU NIF. One of the key objectives of this study is to make an assessment of the risks associated with Ukraine's role as a gas transit country and to recommend an appropriate investment plan to enable Ukraine meet its likely obligations.

Although there is growing understanding in Ukraine's policy community that development of the local currency capital market is a priority area after the crisis, the Bank has been unable to resolve long-standing de facto restrictions on operations in hryvnia and, thus, to support the development of new long-term hryvnia products and help reduce dollarisation over time.

2. OPERATIONAL ENVIRONMENT

2.1 THE GENERAL REFORM ENVIRONMENT

2.1.1 Political Environment

The political environment in Ukraine has been marked in recent years by an absence of policy consensus and sharp disagreements among the presidency, government and opposition. Ukraine had two parliamentary elections and three governments over the past four years, which resulted in a significant slowdown of political and economic reforms. Political uncertainties were exacerbated by unclear and overlapping constitutional authority between the executive and legislative branches. Nevertheless, throughout this period the democratic achievements of the Orange Revolution – genuine if unruly political competition, a pluralistic media landscape and free and fair elections that resulted in a change of political leadership – were preserved.

This period of uncertainty came to an end with the presidential election in February 2010 and the subsequent formation of a pro-presidential government. The new Government is committed to responsible policymaking and the implementation of the vital reforms that were postponed during the preceding Strategy period. This is most evident in the Government’s commitment to fiscal responsibility and structural reforms as enshrined in the IMF programme that was agreed in July 2010.

However, concerns have arisen with regard to the protection of the democratic process in Ukraine. This is particularly true in the areas of media independence and freedom, which have come under pressure in recent months, as well as the proposed reversal of constitutional reforms undertaken in 2004, which were intended to strengthen checks and balances within the political system. Preserving Ukraine’s democratic institutions while strengthening the rule of law, combating corruption and ensuring responsible public policymaking will be essential to Ukraine’s successful transition and integration with European and global markets.

2.1.2 Business Environment

Despite recent improvements, Ukraine continues to face significant institutional and structural reform challenges. The country continues to rank low among its international peers in global surveys of business environment, corporate governance and efficiency. Significant hurdles remain in the areas of competition policy, setting up new businesses and bankruptcy procedures. Businesses face difficulties when accessing land, which remains largely non-tradable. Ukraine's future macroeconomic stability depends to a large extent on the authorities' ability to implement fiscal consolidation, following the rapid increase in public debt during the crisis.

Improving the business environment and reducing corruption are key structural reform priorities which are likely to have a direct impact on the inward flow of foreign investment. Objectives in the institutional area include the establishment of fair conflict resolution procedures (including political checks and balances, honest courts and public administration), the resolution of long-standing uncertainty about land ownership and use rights, and the avoidance of policies that could be perceived as unfair by investors. This should help create conditions for diversifying export sectors away from energy intensive and low value added steel and chemicals.

2.1.3 Physical Environment

Ukraine is one of the largest countries in Europe with rich natural resources, including important energy sources such as coal and large mineral deposits. Around 17 per cent of its territory is covered by forests and about half of the country is covered with exceptionally fertile chernozem ("black earth") soil. Most of the country is upland plain, with the Carpathian Mountains in its western part and a lowland area of wooded bogs and marshlands in the north. Two rivers of high regional importance, the Dnipro (Dnepr) and the delta of the Danube, are located in Ukraine.

The environmental situation in Ukraine is mainly defined by the legacy of extensive agriculture, mining, metallurgy, heavy industries and nuclear power sectors, receiving development priority in Soviet times. Since independence in 1991, the initial collapse of industries reduced pollution, but subsequent economic and social growth significantly contributed to deterioration in air and water quality and land contamination. These, together with the remaining effects from the Chernobyl NPP catastrophe, contribute to a number of environmental problems in Ukraine. Key concerns remain around the quality of the Dnipro River water as a main drinking water source, poor air quality in major cities caused by pollution from industries and transport, hazardous waste accumulation with high environmental and health risks (e.g., potassium mine tailings in Kalush, uranium ore waste in Dneproderzhinsk), industrial and solid waste storage and disposal problems, soil erosion and contamination, deterioration of nature resources and loss of biodiversity, high greenhouse gas (GHG) emissions among other issues. Additionally, outdated and dilapidated infrastructure and industrial assets represent a high health and safety risk of accidents and emergencies as well as water and energy inefficiencies and potential harm to the environment.

The Ukrainian government recognises the importance of addressing current environmental problems and over time has developed the legal and regulatory framework for this purpose. A number of environmental protection policies, programmes and concepts were prepared, setting out strategic directions of sustainable development implementation at a national level.

However, it is critical for Ukraine to ensure that sufficient political will, financial resources and adequate mechanisms for effective implementation of these commitments into practice, are made available.

More information on environmental and social issues, their governance in Ukraine, international cooperation in the area, civil society participation and other relevant environmental and social developments is provided in Annex 4.

2.1.4 Legal Reform

Over the period of the last strategy there has been some relevant new legislation in the commercial sector; most notably the new Joint Stock Company Law entered into force in 2009. In addition, certain areas of activity for corporates and individual entrepreneurs have been de-regulated such that licences are no longer required. However, there remain important gaps and inconsistencies in the commercial law sector. In particular, whilst the new Joint Stock Company Law (the "Law") has generally been positive, protection of minority shareholders remains a problem and many changes such as provisions on the issue of convertible shares have been left to be regulated through adoption of regulations pursuant to the new Law and such regulations have not yet been adopted. Partly as a result of the financial crisis and the conditions imposed on further IMF funding, Insolvency and Tax law reform have been identified by the government as a priority reform for the next strategy period. There has been limited progress in reforming the judiciary and related institutions which remain ill-equipped to meet investors' expectations when compared with other EBRD countries of operations. This was exemplified during the last strategy period when a Supreme Court resolution stated that shareholders' agreements relating to a Ukrainian company must not be governed by foreign law and Ukrainian courts must have exclusive jurisdiction to resolve any related disputes. As a result, foreign investment in Ukraine has largely been made in off-shore holding companies where shareholder rights can more clearly be enforced by other courts and arbitral tribunals under foreign law. For a detailed review of Ukrainian commercial legislation see Annex 3.

2.2 PROGRESS IN TRANSITION AND THE ECONOMY'S RESPONSE

2.2.1 Macroeconomic Conditions for the Bank's Operations

Ukraine's economy underwent a very sharp adjustment in 2008-2009. A collapse in demand for metals and chemicals together with a rise in gas import prices diminished the contribution of net exports to growth. Domestic demand suffered from the reversal of external capital inflows as well as banking sector instability and de-leveraging. As a result, total output contracted by 14.8 per cent in 2009. After losing almost half of its value, in 2009 the Hryvnia was de facto re-pegged to the US dollar and was supported through the crisis by selective central bank interventions and exchange control measures. The public sector balance sheet deteriorated rapidly as the authorities increased spending to cushion the impact of the crisis. In 2009, the overall deficit of the general government, including recapitalisation of nationalised and state-owned banks and national gas monopoly, reached 11.3 percent of GDP in 2009 and around 10 percent of GDP in 2010.

The economic situation has improved more recently. Real GDP increased by 3 per cent (year-on-year) in the fourth quarter of 2010, and industrial output increased by 10.5 percent (year-on-year) in the first two months of 2011. Investor confidence improved following the February 2010 Presidential elections and especially after the authorities reached agreement with the IMF on a new medium-term arrangement in July 2010. Yields on public sector debt declined, the stock market has recovered and the central bank has been able to replenish foreign exchange reserves. However, competitiveness gains from the 2008 devaluation have proven short-lived as the rate of inflation has remained high.

The process of gradual recovery is expected to continue over the medium term. Stronger consumer confidence, lower interest rates and recovery of the financial sector should lead to greater domestic demand while exports would stabilise after the rapid recent recovery. Higher investment related to the 2012 European football championship is expected to support economic activity. The recent strengthening of the independence and accountability of the NBU and the setting of price stability as its primary objective, once credibly implemented, should help bring down inflation over time and strengthen public confidence in the economy. However, downside risks remain considerable and partly reflect the authorities' ability to deliver on commitments under the IMF-supported programme. Domestic consumption and investment are expected to remain vulnerable as households adjust to higher food and energy prices, and corporations improve their balance sheets. The stock of foreign currency short-term debt remains large. After a rapid build up of the public debt during the crisis, the fiscal sector requires credible adjustment as government's access to capital markets is likely to remain difficult over the medium term. Although exports are less energy- and resource-dependent than in the neighbouring countries, the share of high value added manufacturing is small. The government needs to focus on strengthening of the business environment and tackling endemic corruption in order to improve the country's image among existing and potential investors and attract large, high-quality investments required to reduce country's dependence on low value added and energy-intensive export sectors.

2.2.2 Access to Capital

Cost of capital for Ukraine has increased during the crisis and is expected to remain above the pre-crisis level over the medium term as emerging market risks continue to be differentiated in line with their fundamentals. During the crisis emerging market countries with weak institutions, pegged exchange rates, large current account deficits, including Ukraine, suffered from greater loss of confidence than better run transition economies. As the banking sector continues to de-leverage and the government attracts a greater share of local currency savings to cover the fiscal needs, the private sector continues to suffer from limited access to finance. Households and MSMEs remain largely cut off from credit. Although the equity market has recovered much of the losses, the ability of enterprises to attract equity finance through the stock market remains limited. The corporate bond market is nascent, although the Eurobond market has begun to recover recently. FDI declined during the crisis and remains low. Developing a well functioning local capital market and encouraging local currency lending will be crucial to Ukraine's economic recovery and future prosperity.

2.2.3 Reform Progress and Remaining Transition Challenges

Ukraine continues to face significant institutional and structural reform challenges across the board. Despite recent improvements, Ukraine ranks low among its international peers in global surveys of business environment, corporate governance and efficiency. Significant hurdles remain in the areas of competition policy, setting up new businesses and bankruptcy procedures. Businesses face difficulties when accessing land, which remains largely non-tradable. Ukraine's future macroeconomic stability depends to a large extent on the authorities' ability to implement fiscal consolidation, following the rapid increase in public debt during the crisis.

Improving the business environment and reducing corruption are key structural reform priorities. Objectives in the institutional area include establishment of fair conflict resolution procedures (including political checks and balances, honest courts and public administration), the resolution of long-standing uncertainty about land ownership and use rights, and the avoidance of policies that could be perceived as unfair by investors. This should help create conditions for diversifying export sectors away from energy intensive and low value added steel and chemicals.

Ukraine continues to face important reform challenges in all main sectors (summarised in Annex I). Reform progress will directly affect the risk perception and country risk ratings of Ukraine, and therefore investment.

Key challenges with operational implications for the EBRD over the medium term will include:

Strengthening energy efficiency and energy security

Ukraine is a major net importer of oil and gas and an important transit country. At the same time, its economy remains one of the most energy-intensive and inefficient in the region. The energy sector has suffered from years of serving primarily quasi-fiscal or political, rather than commercial, objectives. Ukraine's accession to the Energy Community with the EU creates conditions for the energy sector reform, greater energy efficiency and conservation and support Ukraine's ambition to remain an energy transit country.

The key challenge in the **natural resources** area is the modernization of the gas sector. Following on the recent steps required to integrate Ukraine in the European Energy Community and the decision to raise domestic gas prices to import parity levels, the state-owned energy company, Naftogaz, should be corporatised, unbundled and be made more transparent to strengthen its financial viability and help raise additional finance to modernize the gas transit system. The regulatory framework has to be improved to mitigate the impact of the still monopolised market structure. The state run coal sector remains inefficient, with many mines financially unviable. Challenges to private investment into oil and gas extraction include price regulations as well as administrative obstacles.

Although the **power** sector is unbundled and partly privatised, reforms are far from complete. The wholesale market is not yet operational. Competition in retail and generation is constrained by the dominance of state-owned incumbents. Until recently, the regulator has been politicised although the authorities are attempting to provide it with more independence. Transmission tariffs, although close to recovery levels, do not encourage efficiency improvements and network extension. Ukrenergo is not yet corporatised.

Unlocking Ukraine's agricultural and industrial potential

Ukraine carries great potential across the whole **agribusiness** sector and is capable of helping to address global food security challenges over time. Specific challenges in the sector include raising farming efficiency and yields, improving farmers' access to financing, developing storage, transport and distribution infrastructure, modernising food processing and agricultural processing especially in industries with strong linkages to other sub-sectors, across the whole economic value-added chain, and supporting the development of local companies with high potential, which have been among those the hardest hit by the crisis. Uncertainty about the future of the land ownership limits investment and yields in the sector as large swathes of agricultural land remain under- and un-utilised. Recent government intervention and the imposition of grain export restrictions are having a negative effect on grain producers.

The **manufacturing** sector is expected to benefit from Ukraine's recent accession to the WTO and the deep and comprehensive trade area under negotiations with the EU. However, the sector has suffered during the crisis from the collapse of commodity prices during the crisis (especially steel in late 2008), gas price increases, un-hedged foreign currency borrowing after the devaluation and reliance on short-term whole sale borrowing to finance long-term investment projects. The Governments failure to meet the VAT obligations in 2008-10 in a timely manner had a major negative impact on many export oriented enterprises. Close links between business and politics, weak corporate governance and transparency, and poor enforcement of competition hamper industrial development and inward investments. High value added, export-oriented companies are yet to emerge on a significant scale.

Providing good quality and reliable infrastructure

Recent years witnessed some improvement of the transport and municipal infrastructure in Ukraine, which suffered during Ukraine's prolonged transition recession.

In the **transportation** sector, reforms progressed in the road sector but are significantly delayed in railway and ports. As the state's ability to allocate significant investment resources to this sector will be limited after the crisis, it will be important to engage the private sector in the rehabilitation and maintenance of roads and seaports through competitive Public-Private Partnerships (PPPs), output based contracting and expanding best practices to the regional road, which continue to suffer from neglect. The railway sector continues to be operated by an integrated state-owned national railway company, which makes it difficult to mobilize transparent financing and encourage efficiency through competition. Seaports are also under state ownership, although, the number of privately owned terminals is increasing. After permitting the entry of low cost carriers in 2008, progress in liberalization of the aviation market has stalled.

Although **municipal services** are decentralised, they continue to suffer from politicization of tariff setting and utilities governance at the local government level and central government restrictions on municipal guarantees. The utility setting is expected to be less politicised as new independent regulator of municipal tariffs (district heating and water) becomes fully operational. Poor cost performance, including wasteful energy use remain key challenges in the municipal utilities sector, and needs to be addressed with bold cost restructuring and focus on commercially and economically viable projects.

Dealing with the legacy of the crisis in the financial sector

After expanding rapidly during the pre-crisis years, the **banking** sector suffered badly during the crisis from the combined effect of weak governance, large scale foreign currency lending to un-hedged borrowers as well as poor institutional environment. The government nationalised three medium sized banks and expanded balance sheets of two large state owned banks. The sector remains fragmented and, thus, difficult to supervise. Lending to SMEs suffered in the credit crunch, and mortgage lending seized. The challenge for the sector is to re-start lending to the real sector without returning to the pre-crisis vulnerabilities. This will depend to a large extent on the authorities' ability to establish supportive macroeconomic and regulatory policy frameworks and stimulate development of the local currency capital market. Several IFIs could be instrumental in this area by expanding the range and maturity of the hryvnia products available in the market.

The **non-bank financial sector** and financial sector infrastructure remain underdeveloped. Market for insurance, leasing and asset management products remains small. The pension system — still dependent on very large and unsustainable pay-as-you-go pillar — is yet to undergo a structural reform. The leasing market also remains small.

3. STRATEGIC DIRECTION AND OPERATIONAL PRIORITIES

3.1 THE BANK'S PRIORITIES FOR THE STRATEGY PERIOD

The overarching strategic directions of the Bank reflect the assessment of remaining transition challenges, and are in line with the government's reform programme. The strategic priorities include the improvement of energy efficiency across all sectors; integration into the European energy market and strengthening energy security; promotion of competition and economic diversification as Ukraine moves towards deeper integration into global production and supply chains; support for unlocking Ukraine's enormous potential in food and agribusiness and thus helping food security in Ukraine as well as the region and globally; modernisation of Ukraine's outdated infrastructure, especially upgrading transport corridors and commercialisation of municipal utilities; and stabilising the financial sector and facilitating local currency and local capital markets development. The Bank will focus on addressing the key transition issues in close coordination with other IFIs and bilateral donors.

The Bank's key cross-sector priorities and principles in the strategy period will be:

- The size, pace and conditionality of the Bank investment will be appropriately prioritised to the level of macroeconomic and financial risks in Ukraine.
- Champion transparency, private ownership, best business practices and good corporate governance, including through increased equity participations.
- Although a primary focus will be on development of the private sector, the Bank would support key projects in energy and infrastructure under sovereign guarantees, conditional upon reforms. This could lead to public sector financing having a more prominent role than in the past when the authorities' ability to deliver reforms in a coordinated manner was constrained. Such financing will respect conservative fiscal policy that the government is committed to and has agreed with the IMF.
- Special focus on investments in energy efficiency, carbon emission reduction and environmental improvements. Promotion of carbon finance instruments.
- Facilitate broader demonstration effect of increased investment and improved corporate governance through a carefully selected large domestic business groups which meet the Bank's integrity guidelines.
- Continue to build country based resources located in Kyiv and include legal and economic advisors to enhance policy dialogue and assist in linking broader reform goals with Bank investment under the integrated approach that combines the development of a mid-term project pipeline with a targeted and longer-term strategy for policy dialogue and technical support to the reform agenda.
- Through a more active and focused policy dialogue, the Bank will seek to develop closer links with key government officials such that the Bank can become more effective in delivering support.

While the Bank's overarching strategic focus will remain on private sector development, where a key focus will be to assist Ukraine in the development of its knowledge intensive industries and its better use of its human and scientific potential. The Bank will also seek to increase its operational activities with the public sector to support much needed infrastructure development and to enhance its policy leverage with the new government, which has demonstrated willingness and capacity to undertake meaningful structural reforms. However, the level of the Bank's investment in Ukraine will depend on the implementation of reforms in all main sectors, while slow reform progress and deteriorating investment climate will inevitably lead to reduced investments by the Bank in the public and private sector respectively.

The Bank will underpin its operational objectives by ongoing policy dialogue on a wide range of issues, with the view to supporting the authorities' economic reform programme, and in consultation with other IFIs and bilateral donors. Priority policy dialogue areas include:

- Continue to promote rule of law and fair treatment of all investors, a tax regime conducive to business with efficient and timely VAT refunds, and a legal and regulatory system that respects property rights and security agreements.
- Promote energy efficiency policies, including in the context of the Eastern Europe Energy Efficiency and Environmental Partnership (E5P) initiative of the EU, and revalidate with the new government the Sustainable Energy Action Plan (SEAP) signed

with Ukraine in 2009. Support the development of legal and regulatory frameworks supporting clean energy and energy efficiency investments.

- Develop a positive cooperation with the NBU, defining roles for each NBU and EBRD in developing local capital markets, including in addressing and resolving outstanding issues which preclude IFIs from financing in local currency and managing local currency accounts.
- Where possible promote, through the provision of technical assistance funds, the training of companies in the municipal and state sectors and local self-governance bodies that co-operate with the Bank, including areas such as financial and economic project analysis, project management and procurement practices.

The success of the Bank's ambitious operational strategy in Ukraine is subject to a number of risk factors. First, external economic risks remain high given the fragile recovery in Europe and still volatile financial markets and commodity price movements. Second, rising NPLs could undermine the domestic recovery, particularly if combined with a failure to improve the weak business environment and perceptions of endemic corruption. Third, the political commitment to reform could be undermined in response to "reform fatigue" and political pressures, e.g., in connection with the parliamentary elections scheduled for autumn 2012.

These risks could reduce domestic investor and consumer confidence, particularly if they were to negatively affect IMF programme implementation, and thereby reduce the prospects for normalizing access to international capital markets and attracting the much-needed FDI. Slow reforms, combined with high economic instability and low investor confidence, would inevitably lead to reduced investment by the Bank, particularly in the public sector. The Bank will therefore continue to monitor closely the risks to its portfolio and pipeline in Ukraine, including in the broader context of the Bank’s overall portfolio.

3.2 SECTORAL CHALLENGES AND BANK OBJECTIVES

The sector challenges and objectives outlined below are presented in a priority order for each sector.

3.2.1 Energy

Energy security is a major policy issue in Ukraine, and its dependency on external supplies is exacerbated by the low efficiency of energy use. Improving energy efficiency is therefore a key priority for the country. The Bank will support diversification of the sources of energy, improving energy security and energy efficiency, and the development of renewable energy. This will include safety upgrades in the nuclear sector, electricity transmission networks, and operations that would integrate Ukraine into the European energy market. The Bank would also support the modernisation of Ukraine’s gas transportation and distribution system, provided the authorities pursue a comprehensive and credible reform agenda, including restructuring of NAK Naftogaz. Safety for the NPPs, which produce almost 50 per cent of electricity in Ukraine, is also of high priority.

Policy dialogue will focus on promoting privatisations of non-strategic state enterprises as well as corporatisation and further commercialisation of the key remaining state enterprises (NAK Naftogaz, Ukrenergo, etc). In the electricity sector, the Bank would promote reform of the wholesale electricity market leading to the replacement of the single buyer market with a bilateral contracting market, tariff reform moving towards full cost recovery, strengthening the independence of the sector regulator NERC, and the corporatisation of Ukrenergo. In the gas sector, working with the other IFI's and the EU to enact critical structural reforms and improved transparency, governance and restructuring of the state-owned energy company Naftogaz.

The Bank's operations will focus on:

In the power sector

- Pursuing the implementation of an integrated approach to reform in the Ukrainian power sector, combining development of a mid-term project pipeline with a targeted, longer term strategy for policy dialogue and technical support for the market reform agenda in the transmission and generation sectors.
- Modernisation of the transmission network, including its integration with the neighboring markets and providing electricity to energy-deficient regions of Ukraine.
- Development of renewable energy generation capacities, including under the Ukraine Sustainable Energy Lending Facility (USELF) and for rehabilitation of existing hydro power plants.
- Support to gradual de-carbonisation of energy generation through the rehabilitation of existing power generating assets, including improvement in efficiency and environmental performance of thermal generation.
- Where appropriate, participating in privatisations leading to introduction of reputable strategic investors and increased competition.

In the natural resources sector

- Support of modernisation of the gas transit system along with other IFIs in connection with the sector reform and corporatisation and un-bundling of the state owned NAK Naftogaz, and the possible provision of energy efficiency finance.
- Support to greater local sourcing of oil and gas, reducing dependency on imports – where possible with the implementation of modern technologies to maximize the efficient and safe exploitation of oil/gas deposits, combined with CO^2 sequestration.
- Further support of the private sector – both upstream and downstream activities – including by improving refining quality and reducing the environmental impact.
- Support of mining projects leading to greater transparency, improvement of health and safety standards or energy efficiency. The Bank will consider developing an integrated approach in the area of mine safety, including policy dialogue in this area, once the authorities focus on this subject following effective creation of the new Ministry of Energy and Coal.

In nuclear safety

- Following the successful completion of the EBRD/Euratom K2R4 programme, financing nuclear safety upgrades to bring the other 13 units to the same internationally accepted safety levels, in line with the EBRD's Energy Policy.
- Continued support for decommissioning of Chernobyl NPP and transformation of the object shelter over Unit 4 into an ecologically safe system. The Chernobyl projects funded by EBRD managed donor funds and supported by an EBRD EUR 135 million grant will reach a crucial phase in 2011. The contract for the supply of equipment and construction of the spent fuel storage facility ISF-2, which provides a solution to one of the most significant safety issues at the site and is a prerequisite for the safe decommissioning of units 1, 2 and 3 of Chernobyl NPP, is scheduled to receive a license for operation in 2014.
- Proceeding with implementation of the SIP as it reaches a decisive point. Construction of the key project within the SIP, the NSC, and fabrication of the structural steel are scheduled to start in spring of 2011 after regulatory approval of the corresponding licensing package. The overall NSC design, including all its auxiliary systems, should be finalised and receive regulatory approvals in 2011. When completed in 2014 and slid into place it will enclose the radioactive inventory of the site and allow for safe deconstruction and waste management activities over a period of 100 years.
- Helping address the challenge of filling a large funding gap which needs to be bridged in order to complete the projects. G8/EU and Ukraine, with the support of the EBRD, are working together to raise the required EUR740 million with a view of holding a pledging event in April 2011 to coincide with a high level international conference to commemorate the 25th anniversary of the Chernobyl accident. Successful implementation of these uniquely complex projects will require professional excellence by the contractors and the Chernobyl NPP with its Project Management Units. It will also require dedication and close co-operation of the Ukrainian administrative and regulatory authorities. The Bank, together with its Ukrainian counterparts, will continue to play a major role in ensuring an environment conducive to making good progress and completing the projects as scheduled in 2014.
- Assuring ongoing high-level policy dialogue with the Ukrainian authorities for their commitment to implementation of projects operating under the EBRD's CSF and Nuclear Safety Account, smooth regulatory review processes, effective action to support nuclear liability frameworks, and provision of dependable state budget support. Recognise that both funds need further significant contributions from donors.

3.2.2 Enterprise Sector

A key objective for the Bank will be to promote recovery and modernisation of the corporate sector and enhancing its export capacity. The Bank will support FDI and cross-border transactions, in particular linked to the introduction of new technologies or increased competition. Investments will be focused on helping to diversify the economy and restructure old energy-intensive industries with a focus on improving their governance, transparency and energy efficiency. The Bank will support the government's privatisation programme of remaining state enterprises. In recognition of Ukraine's great potential as an agricultural producer and exporter that can contribute to addressing global food security issue, Bank will support investments along the whole food value chain and especially those instruments that support primary producers, including seasonal working capital. Where appropriate, the Bank will support corporate restructurings and utilise its unique position to achieve consensus based solutions amongst lenders to troubled companies. The Bank will also promote investment by private sector, including non-financial assistance provided through the TurnAround Management (TAM) and Business Advisory Services (BAS) programmes and technical cooperation (TC) assignments such as the Ukraine Micro Lending Programme. Policy dialogue will focus on creating an improved investment climate and promoting legal reform covering areas such as insolvency, the promotion of greater security of land ownership and usage rights.

The Bank's operations will focus on:

In agribusiness

- Pursuing the implementation of an integrated approach to develop and improve physical infrastructure and increase access to financing in the grain value-chain.
- Increasing efforts in financing and attracting new investments linked to energy efficiency, emission reduction, environmental improvements, in particular through utilisation of new initiatives such as the proposed Agribusiness Sustainable Investment Facility.
- Supporting industries with strong upstream and downstream linkages to other sub-sectors as well as higher value added sectors, such as logistics, food processing and retail.
- Supporting local and international commodity market players by providing working capital financing (including for pre-harvest financing), indirectly injecting much needed capital into the farming sector through backward linkages.
- Increasing access to financing, including by small farmers, by further developing the warehouse receipt programme, introducing and developing the new crop receipt instrument for pre-harvest financing of farmers and other market-based structures for commodity operations, and promote their utilisation. Work with partners banks to extend longer-term financing to small and medium agricultural producers.
- Facilitating investment into meat production and dairy businesses.
- Developing a suitable financial infrastructure to increase investment into agriculture (including commodity collateralisation instrument, insurance and commodity exchange improvements), promote greater transparency and predictability of policy interventions and better global policy coordination, promote best practices in sustainability management and maximising environmental and social benefits.
- Pursuing policy dialogue in coordination with other IFIs with a focus on supporting land reform, as well as providing financing to projects after its successful implementation, addressing global food security concerns.

In manufacturing and services

- Introducing best practices in areas including, but not limited to, technology improvements, resource-use efficiency, finance/accounting, corporate management and gender.

- Supporting industries that target local consumers, such as pharmaceuticals, household goods, packaging, construction materials, and retail.
- Supporting the entry of new strategic investors.
- Adopting a more flexible approach to supporting companies impacted by the financial crisis and, where appropriate, considering refinancing/restructuring of existing debt to achieve an appropriate debt structure, including the provision of working capital.
- Supporting viable companies in the old energy intensive industries such as steel and metals for energy efficiency and environmental improvements.

In property and tourism

- Focusing on projects that support the development and renewal of real estate infrastructure for the retail sector and logistics, and for the general corporate sector (offices and industrial parks), as well as hotel developments where sponsors are cooperating with experienced operators. Priority will be given to the regions outside the capital, where supply and demand imbalances persist in all the sub-sectors of the commercial real estate. Selectively consider projects with high demonstration effects in the capital city.
- Supporting other projects if they contain specific energy efficiency initiatives in line with the new guidelines on integrating low-carbon transition.

In telecommunications, informatics and media

- Promoting further liberalisation and increased competition across sub-sectors, leading to improvement of both quality and cost to consumers.
- Supporting the privatisation, structural reform and modernisation of the state-owned assets while ensuring the transparency of the process.
- Providing financing to alternative operators - broadband, cable TV, wireless, satellite, data centres and system integrators.
- Supporting investments into technology alongside organisational, commercial, social and legal innovations to promote technology-related industries.

In equity funds

- Strengthening of the industry capacity through the support of both first time and successor funds, which can demonstrate a strong management team with a hands-on management style and capable of adding value to portfolio companies. Support the development of local fund managers with experience and knowledge of the market; but also regional fund managers capable of creating strong local teams.
- Using equity funds as an efficient intermediation vehicle to enhance the provision of equity financing to corporate sector, focusing primarily on small and medium sized enterprises and “Mittelstand” segment.
- Facilitating the development of innovative financing tools through the participation in funds, which have sector-specific strategy (such as, for example, agribusiness) or offer specialised products (such as, for example, mezzanine capital).

- In a challenging fundraising environment in the region, selectively providing increased percentage participation for new funds in the first closings.
- Continueing the efforts in attracting international and local investors of institutional quality to the private equity market in the country.

In Turn Around Management / Business Advisory Services (TAM/BAS)

- The EBRD will continue promoting economic transition through the BAS and TAM programmes via advice and mentoring at the enterprise level and the development of a sustainable infrastructure of business advisory services, as well as seeking to improve policy and regulatory environment for business through policy dialogue. Financial support will be available through the Strategy period from the EU Eastern Partnership facilities.
- BAS that was launched in Ukraine in 2010, will focus initially on building awareness of benefits of consulting for SMEs and training of local consultants. With time BAS will further support MSMEs efforts in improvement of production quality and market performance, including broadening export opportunities, improvement in business processes and standards as well as business sophistication and FDI attraction.
- TAM will re-start regular operations in Ukraine in an improved format (shorter projects and more flexible in consultant selection criteria) with a focus on improving competitiveness, transparency and business standards in mid-sized companies. TAM will be part of an important randomized impact study to compare results of companies benefiting from TAM interventions vs. private consultancy and enterprises with no external advisors serving as the control group.

3.2.3 Infrastructure Modernisation

The Bank will focus on improving the quality of public infrastructure while reducing its impact on public finances. Although municipal services are decentralised, they continue to suffer from politicisation of tariff setting and utilities governance at the local government level and central government restrictions on municipal guarantees. The utility tariff setting is expected to be depoliticised as a new independent regulator of municipal tariffs (district heating and water) comes into effect later in 2010. Energy efficiency in the district heating sector is a key challenge. The newly established E5P has been created to provide grant and TC funding to address this.

In the road sector, the Bank will support the completion of the modernisation of the main transport corridor connecting the country to the EU. The Bank will continue to promote commercialisation of municipal utilities through projects with large demonstration effects or energy efficiency gains. The railway sector, which continues to be dominated by an integrated state-owned national railway company and which has suffered from the emergence of major bottlenecks before the crisis-related recession, can be supported only after the authorities make credible steps to corporatise the national rail operator and permit entry of private operators. After permitting the entry of low cost carriers in 2008, progress in liberalisation of the aviation market is important. It will be necessary to increase dialogue and cooperation with other IFIs on the reform agenda, and in co-financing larger projects.

The Bank’s operations will focus on:

In municipal and environmental infrastructure

- Implementing energy efficiency and environmental projects as a matter of priority with co-financing and TC support from the E5P fund or other donor sources.
- Continuing to support commercialisation of municipal utilities and enterprises through projects with large demonstration effects where there is evidence that sustainable and superior services can be provided.
- Shaping key product offerings on improving district heating, water and wastewater, but also urban transport and solid waste management solutions.
- Where the preferred sub-sovereign financing model is not practicable for structural or credit reasons (including large infrastructure projects which are regional in nature or not affordable for the local communities), the Bank will consider sovereign financing.
- Supporting private sector involvement in the provision of municipal services in accordance with transparency and concession standards acceptable to the Bank.
- Supporting fiscal decentralisation and municipal reforms. Amendments to the recently enacted Budget Code would be needed to facilitate fiscal decentralisation and municipal reforms, including through sub-sovereign borrowing.
- Developing an integrated approach in the area of district heating with policy dialogue around the regulatory regime.

In the transport sector

- In the road sector, completing the modernisation of the European corridor, continuing key sovereign projects, which exhibit strong demonstration effect and conditionality on sector-wide reforms and, where appropriate, expanding best practices to the regional road networks, which continue to suffer from neglect.
- Exploring viable opportunities for engaging private sector in the rehabilitation and maintenance of infrastructure through competitive PPPs and output based contracting.
- Supporting private sector initiatives in seaports and privately owned terminals.
- In the railroad sector, supporting emerging private sector operators in freight and wagons. In the state sector, any new financing to be conditional on progress in the corporatisation of the state-owned national railway company.
- In aviation, supporting upgrades of air navigation systems, and promoting liberalisation of the aviation market along the “open skies” policy.

3.2.4 Financial Sector and Capital Markets

The main priority for the Bank in the short term is to help stabilise the financial sector and continue to address the need to develop the local capital markets and includes providing the banking sector with targeted long-term equity and debt funding together with technical assistance to help support activities that will help to limit the sector’s future instability, including strengthening governance, diversifying long-term funding sources and supporting the development of local capital markets. The lending instruments would focus on MSMEs, financing energy efficiency improvements and trade facilitation, with the use of appropriate technical assistance. The Bank will work with other IFIs and the NBU to address gradually the challenge of building up local capital markets under the EBRD's Local Currency and Capital Market Initiative and also remove remaining obstacles in the way of IFIs lending in local currency.

The Bank's operations will focus on:

- Strengthening the capital base of banks by investing equity and subordinated debt to help stabilise the banking sector.
- Once private banks have stabilised their balance sheets, supporting post-crisis recovery of financial intermediation through the provision of dedicated long-term credit lines for energy efficiency and SME/MSME.
- Continuing the engagement with commercially-run state banks to ensure some lending and related institutional strengthening.
- Providing trade finance facilities to support recovery of international trade.
- Supporting financial institutions in tapping international debt and capital markets through participation in syndicated loans, securitisations, and other appropriate instruments, in order to improve the diversity and terms of external long-term funding sources.
- Supporting the emergence of leasing, insurance and pension products.
- Once appropriate local currency instruments become available, offer sustainable mortgage and consumer finance with appropriate risk mitigation and disclosure.
- Expand access to sustainable energy finance through the banking and leasing sector.
- Considering the issuance of long-term hryvnia bonds once regulatory constraints are addressed.

Key policy dialogue activities in the financial sector will focus on:

- Working with the NBU and the government on policies needed to develop local currency finance, a key to less volatile growth, helping to mobilise domestic savings, making Ukraine less dependent on capital imports and reducing currency risks.
- Promoting best regulatory and lending practices, reversal by the NBU of some of the unorthodox, crisis management policies; involving more efficient loan structuring security sharing and inter-creditor agreements to support more effective long-term syndicated lending by banks; development of an efficient credit bureau system.
- Supporting policies that will encourage consolidation and improved transparency in the banking sector, un-winding state participation in the nationalised banks and more efficient resolution of failed banks.

3.2.5 Environmental and Social Impact

All the Bank's projects are subject to the EBRD's new Environmental and Social (E&S) Policy that entered into force in 2008. It establishes a set of ten Performance Requirements for clients to integrate environmental and social considerations in their business operations, and introduces best practice for management of environmental, occupational health and safety, labour and other social issues. The Policy and Performance Requirements has been translated into Ukrainian. All EBRD operations in Ukraine undergo the Bank's environmental and social appraisal. Issues raised during due diligence are then addressed in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investments.

In the past three years the Bank had a number of projects in the **power and energy** sector, mainly construction of transmission lines, hydropower upgrades and development of high efficiency combined cycle turbines for industrial operators. Due to the nature of land allocation a number of environmental and social impacts have been associated with electricity transmission projects, including resettlement and livelihood restoration, deterioration of ecosystems, and health and safety concerns for workers and people living in vicinity to high voltage lines. The EBRD will continue to work with its clients, including Ukrenergo, to ensure application of international best practices in the area of environmental and social impacts assessment, their mitigation and adequate public engagement and dialogue.

The Bank will support projects helping to shift from fossil fuels power generation to use of renewable sources to assist Ukraine's efforts in mitigating climate change and improving overall security of supply. At the same time the Bank will continue to support existing fossil fuel operators in improving efficiency and reducing their environmental impact. As part of this effort the Bank sat up a EUR 50 million USELF in 2010 to provide debt financing for renewable energy and industrial energy efficiency projects. As part of this Facility, a Strategic Environmental Review is currently being carried out to identify best possible locations for renewable projects in Ukraine. Additionally, the E5P was initiated under the Swedish Presidency of the EU in 2009 with its main focus being on energy efficiency projects in Ukraine.

In the sector of **natural resources,** the EBRD takes a consistent approach in applying its E&S Policy, although impacts differ significantly depending on the project. The Bank encourages each of its clients to follow international best practice, such as the Extractive Industries Transparency Initiative. The Bank will also help its clients to identify environmental offsets and opportunities for environmental and social investments at the local level. With respect to mining projects the Bank's focus is on minimising the land take or footprint, sound practices for the use, handling and storage of hazardous materials, safe storage of tailings, preventing adverse impacts to water resources and the early development and funding for reclamation.

Ukraine has a major ferrous metal industry, producing cast iron, steel, and steel pipes, and chemical industry produces coke, mineral fertilizers, and sulphuric acid. In recent years the Bank's **manufacturing industries** projects focused on ferrous and non-ferrous metals, chemicals, plastics, mineral products and pharmaceuticals production. Key issues in this sector are associated with air emissions, waste and waste water management, nuisances to the public and environmental liabilities of the final products. EBRD will continue to promote Best Available Techniques implementation to ensure environmental performance improvements by its projects, as well as consider potential social impacts of operations and necessary mitigation measures.

Ukraine is also a major producer of grain, sunflower seeds, and beet sugar, and the Bank's **agribusiness** portfolio and associated trade finance programmes include operations in processing of these crops, grain warehousing and transportation along with investments in breweries, dairy and meat processing and food retail. Although EBRD did not engage in direct financing of primary agriculture in Ukraine, Bank-financed food processing projects have a positive upstream effect, and there is potential in future for sustainability initiatives related to supply chain. The Bank will give high importance to prevention of soil degradation, water and food pollution by fertilisers and pesticides, use of genetically modified organisms (GMOs) and to the implementation of climate change adaptation measure in its future investments.

In the **property and tourism** sector, the Bank was involved in hotel development, retail and logistics centres which had associated issues of planning permitting and public consultation processes, and construction nuisances to public that have been addressed through the environmental and social due diligence and mitigation measures.

In the **financial** sector, the Bank will continue to provide environmental and social risk management training and guidance for its new and existing financial clients in the implementation of the EBRD's environmental and social requirements. An e-manual has been developed to assist financial institutions in developing procedures for environmental and social due diligence in accordance with the EBRD's new 2008 E&S Policy. Ukreximbank can serve as a best practice example winning EBRD's Environmental Awards 2009 by demonstrating continual improvements in its E&S risk management. The EBRD coordinates its efforts with other IFIs, UNEP FI and other initiatives to promote sustainable and responsible financing in the country, and will continue to support Ukrainian intermediaries by providing further capacity building on E&S issues.

The Bank's involvement in the **transport** sector of Ukraine focused in recent years on ports operations and railways rolling stock renewal, supporting an upgrade of infrastructure and introduction of new technologies to improve safety and environmental performance of operations. The Bank's finance to port infrastructure and shipping companies in Odessa is helping in the implementation of UN International Maritime Organisation's environmental and safety standards on pollution prevention and worker health and safety. Significant number of urban transport projects was associated with rehabilitation and modernisation of public transport in such cities as Kyiv, Odessa, and Lviv. The latter will remain one of EBRD's priorities due to its sustainability potential and reduction of GHG emissions from congested traffic of private vehicles in major cities.

EBRD will continue to support improvements in **municipal environmental infrastructure and services** through projects involving district heating, rehabilitation of water, wastewater and waste management facilities that have associated social and economic benefits through cost saving energy efficiency measures and better public health. For instance, high energy efficiency benefits were demonstrated by Zaporizhzhia and Dnipropetrovsk municipal projects. One of the most serious Ukrainian environmental challenges is the problem of household waste disposal and fly-tipping and associated lack of waste segregation and utilisation and land filling capacity. As per Ministry of Environmental Protection of Ukraine, only 6 per cent of rubbish is recycled in Ukraine compared to 30-40 per cent in Western Europe. There is a high potential for Bank's future involvement in this area.

Further information on Ukraine's environmental and labour legal frameworks, international cooperation, civil societies, climate change agenda and nuclear safety is provided in the Annex 4.

As part of the implementation of the EBRD's Gender Action Plan, the Bank will continue to support women's entrepreneurship through Financial Institutions projects by increasing the access to finance for women-owned MSMEs and women entrepreneurs and address barriers that impede access to credit, particularly in rural areas. Also, in the municipal and environmental infrastructure sector, the Bank will seek, where relevant, to promote equitable distribution of project benefits amongst men and women and to enhance the role of women as agents of behavioural change. Gender advisory services to municipal companies will be considered as appropriate, with a view to mainstreaming gender into human resources and/ or service provision. In other priority sectors, the Bank will focus on identifying and encouraging clients to adopt gender balanced approaches in their human resources policies and practices (e.g. work-life balance, flexible working hours, family friendly initiatives, etc).

4. CO-OPERATION WITH OTHER IFIs AND DONORS

The Bank will continue to closely cooperate with other IFIs, the EU and bilateral donors, building on a much enhanced cooperation since the outbreak of the economic crisis.

4.1 MAIN AREAS OF COOPERATION

The main areas of cooperation will include:

- **Policy dialogue alignment**: The EBRD plays a leading role in the policy dialogue with the government and IFIs in general investment climate issues as well as specific sector coordination such as banking sector stabilisation during the crisis, gas transit system modernisation, energy efficiency, and nuclear safety. Together with other IFIs, the Bank will focus on a coordinated dialogue with Ukrainian authorities on key issues related to investment climate, transparency and corporate governance; but also specific initiatives related to food security, energy efficiency and environmental issues as well as the promotion of local capital markets. Ukraine is identified as one of the focus countries for a joint IFI effort to develop local capital markets. Specific effort will therefore be made to enhance local currency funding opportunities. The donor coordination with bilateral donors is well structured and includes monthly meetings. Often, the Bank is also the first point of call for high level representatives of shareholder countries visiting Ukraine.

- **Project co-financing:** Most large infrastructure and energy projects undertaken by the Bank during the past strategy period involved co-financing with at least one other IFI (EIB, World Bank, IFC). This cooperation is expected to continue during the new strategy period. All new public infrastructure and energy projects are prepared together with the EIB on a 50-50 basis and are expected to benefit from grant co-financing and technical assistance from the EU Neighbourhood Investment Facility (NIF). Clean Technology Fund (CTF) concessional finance is available for renewable energy projects, residential energy efficiency, and gas transmission network efficiency. There is often a significant synergy between IFIs in coordination for conditionality of reform components for project preparation and implementation. Note that IFI loans are not subject to the IMF concessionality requirement under the IMF programme.

- **Technical assistance:** The Bank is actively using technical assistance from the EU, bilateral donors and special funds, mainly for project preparation and implementation (mostly in infrastructure, energy, and energy efficiency). The Bank itself made a significant EUR 135 million grant contribution for the projects funded from the CSF and Nuclear Safety Account in 2009. NIF is funding consultants to determine the strategic future of the Ukrainian gas transit system and a bankable investment plan to achieve necessary modernisation. The Bank will also continue pursuing donor financed legal and regulatory TC in key strategic areas, including in gas sector, energy efficiency and others. The EU is the largest provider of donor assistance to Ukraine. Over the years 2005-2008 it contributed to 22 per cent of total donor commitments. Some EU Member States, notably Germany, Sweden, France, the United Kingdom and Austria are also significant contributors, thus bringing total EU commitments to 40 per cent of total donor commitments. International donors are working together to create an integrated platform to discuss policy priorities and better coordinate donor support with government authorities. Work is also under way to create a Strategic Council for Technical and Financial Cooperation, which would bring together the governmental and presidential authorities and the development partners at senior level under the auspices of the Economic Reform Council.

In addition to the specific areas detailed above, the Bank is expecting to work more closely with the EIB over the next strategy period. The EIB will be located in the Bank's building in Kyiv and, as such, a close working relationship is envisaged, particularly on the larger energy, infrastructure and transport deals.

4.2 COOPERATION WITH THE EU

In May 2009, the EU launched its Eastern Partnership (EaP), offering the opportunity for deeper relations between the EU and six neighbouring Eastern countries, including Ukraine, as well as between them. Ukraine has indicated its interest in the comprehensive institution-building programme and the new flagship initiatives foreseen by EaP. As regards technical and financial cooperation, nearly 400 programmes and projects, currently being implemented under the TACIS allocations and the ENP Initiative, continue to contribute to progress in the main strategic areas of the EU-Ukraine Action Plan. The Bank will work with the EU to ensure that its activities are, as far as possible, complimentary to pilot projects under the EaP Pilot Regional Development Programme.

In July 2010, the European Parliament and Council adopted a decision on providing macro-financial assistance (MFA) of up to EUR 500 million to Ukraine. In combination with an earlier Council decision dating from 2002, a total amount of up to EUR 610 million in MFA is now available to Ukraine. This long-term lending facility aims to help Ukraine re-establish macroeconomic stability following the shock of the crisis, foster reforms to raise sustainable growth and promote economic integration and regulatory convergence with the EU. A requirement of this EU MFA operation (as for all MFA operations) is that Ukraine's IMF programme must remain on track.

The EU is currently developing a new National Indicative Programme for Ukraine for 2011-13 to consist of the following priority areas**:**

- Good Governance and the Rule of Law (including reforms in areas of justice, freedom security; border management; public administration and financial management).
- Facilitation of the entry into force of the EU-Ukraine Association Agreement (including a Deep and Comprehensive Free Trade Area)
- Sustainable Development (Energy, Environment and Climate Change, Transport, Regional and Rural development).

The Bank is actively using EU funding for various TC programmes. It is also a key supporter of the E5P initiative where the EU and Sweden are the main donors and the Bank is the leading coordinator and administrator of the E5P donor fund for grant co-financing and TC support.

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, although application of these principles in the previous Strategy period was somewhat uneven. Particular areas of concern include poor governance, high-level corruption, the weak rule of law and lack of judicial independence. A Constitutional Court decision in September 2010, which ruled that amendments to the Constitution adopted in December 2004 were unconstitutional, threatens to weaken the strong institutional checks and balances that have been in place since 2006.

Political Accountability

Ukraine is a multiparty, mixed presidential-parliamentary democracy in which the president is elected directly for a five-year term and the unicameral parliament is elected through proportional representation on the basis of closed party lists. The president appoints the prime minister, who forms the cabinet. The appointments of the prime minister and the cabinet are subject to approval by parliament (the *Verkhovna Rada*).

The Ukrainian Constitution provides for the separation of powers, checks and balances and an independent judiciary. Constitutional amendments which were adopted in December 2004 and came into effect in January 2006 significantly strengthened the powers of the legislative branch and assigned some executive functions to the government. However, those constitutional amendments also resulted in overlapping, and at times conflicting, constitutional prerogatives of the presidency and government, which fuelled political infighting and policy paralysis.

Following a request from the new Government of Ukraine, the Constitutional Court in September 2010 reviewed the 2004 reforms and ruled that they were unconstitutional. This ruling appears to require a reversion to the 1996 Constitution, which concentrated political power in the presidency. While the clarification of constitutional prerogatives is a positive step, and the enabling legislation for the return to the 1996 Constitution is still under consideration by the authorities – particularly a new Law on the Cabinet of Ministers – further development of a democratic system of governance would require that the authorities ensure accountability of the executive branch to the electorate by maintaining an effective system of checks and balances within the constitutional system.

Ukrainian citizens have the right to change their elected leaders through periodic elections held at national and municipal levels on the basis of universal suffrage. Ukraine held one parliamentary election (September 2007), one presidential election (January 2010) and one local election (October 2010) during the previous Strategy period. Both the 2007 parliamentary election and the January 2010 presidential elections were judged generally free and fair by international observers from the OSCE and Council of Europe, as well as by the large and relatively sophisticated network of domestic election monitors. The campaigns for these elections were hard-fought; the media broadcast a broad spectrum of political views and opinions; and reported cases of the abuse of administrative resources and ballot-box stuffing were minimal.

Both the September 2007 parliamentary election and the January-February 2010 presidential election resulted in an alternation of political power. The 2007 parliamentary election resulted in a significant increase in parliamentary seats for the then-opposition Yulia Tymoshenko Bloc, which then went on to form a coalition government with the pro-presidential Our Ukraine-People's Self-Defence bloc and the Lytvyn bloc with Tymoshenko in the premiership. However, the unclear constitutional prerogatives that resulted from the 2004 constitutional amendments combined with severe political infighting within the 'Orange' camp resulted in a period of prolonged political uncertainty and little progress on implementing an effective economic or political reform programme. The January-February 2010 presidential election likewise saw the Ukrainian electorate once again swing to support the opposition, with former PM and head of the Party of Regions, Viktor Yanukovych, winning a narrow victory over PM Tymoshenko in the second round run-off.

While national elections in 2007 and 2010 have been judged to meet standards of free and fair democratic elections, the local elections of October 2010 were marred by a less pluralistic media environment, reported cases of the abuse of administrative resources during the campaign period, as well as allegations of ballot-box stuffing in some highly contested districts. Moreover, a new Local Election Law adopted by the parliament in July 2010 prohibited both party blocs and political parties that had existed for less than one year from participating.

In this context, the key challenge for the new President and Government is to maintain the democratic gains of the past five years while strengthening political stability and the accountability of public policymaking.

The Rule of Law

The basic legal framework to ensure effective governance and the impartial rule of law in Ukraine is adequate: the Constitution provides for an independent judiciary and the enabling legislation for the protection of judicial independence is largely in place. Moreover, President Yanukovych and the Azarov Government have repeatedly emphasised their commitment to improving transparency and accountability and ensuring judicial independence.

However, the rule of law in Ukraine is weak, and both high-level and administrative corruption remain significant challenges. Implementation of the laws and regulations 'on the books' remains a key challenge, and both politically and commercially motivated interference with judicial decision-making remains widespread. Particular concerns relate to the perceived politicisation of the Constitutional Court, which has recently been asked to provide key rulings on the 2004 constitutional reforms, the 2010 local elections and the 2012 parliamentary elections. In September 2010, four of the Constitutional Court's who were widely seen as politically independent were replaced by the High Council of Justice with individuals widely perceived to be loyal to the Party of Regions.

President Yanukovych and his Government have repeatedly asserted that addressing the problem of corruption at all levels of the state is a reform priority. However, there has been little concrete progress in combating corruption since President Yanukovych and the Party of Regions-led Government came to power. While a number of high profile anti-corruption investigations have been launched since early-2010, these have largely targeted members of the former governing parties, giving rise to allegations by members of the opposition that these campaigns are politically motivated. Media exposés of high-level misappropriation and embezzlement, often associated with uncompetitive public tendering procedures, are routinely ignored or dismissed by the authorities. It is yet to be seen whether administrative reforms launched in December 2010, which entail a reduction in the number of both line ministries and cabinet posts, will have a substantive impact on reducing high-level corruption.

Both foreign and domestic investors in Ukraine routinely point to corruption as the most serious challenge encountered in the business environment, as demonstrated by the 2009 EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS). Reflecting this perception, Ukraine scores among the most corrupt countries in the transition region on Transparency International's Corruption Perceptions Index, on which it was ranked 134th out of 178 countries globally in 2010, on a par with Azerbaijan, Bangladesh and Zimbabwe.

Civil and Human Rights

The Government of Ukraine generally adheres to its Council of Europe and OSCE commitments to guarantee the protection of human and civil rights. The Constitution provides for freedom of speech and press, freedom of assembly, association, and religion, and these freedoms are generally respected in practice. However, some developments since the presidential election of 2010 give rise to concern with regard to the protection of civil and human rights in Ukraine.

The independent media in Ukraine flourished in the aftermath of the Orange Revolution, becoming diverse, competitive, and highly pluralistic. Television – which remains the key source of information and news for most Ukrainians – became particularly vibrant, with daily discussion shows on political and social issues attracting millions of viewers, while both the ownership patterns and political affiliation of the print media generally represented the broad spectrum of Ukrainian society.

Since the presidential election of 2010, however, the increasing concentration of media ownership in the hands of Party of Regions' backers has combined with rising self-censorship to dampen the vibrancy and pluralism of the broadcast media, in particular. While diverse views continue to be represented, opposition politicians in particular complain that their access to the media has been limited by journalists and editors anxious to conform to the authorities' political objectives. Television coverage of the Party of Regions' programmes, in particular, has become significantly less critical than was the case under the previous government. The as-yet unsolved disappearance of Vasyl Klymentyev, editor-in-chief of the Kharkiv-based newspaper *Novy Stil*, who was actively investigating allegations of corruption in the regional administration, is a cause for concern amongst media watchdogs.

The non-governmental organisation (NGO) sector in Ukraine likewise flourished in the post-Orange Revolution period, as the number and professionalism of both political and non-political NGOs increasing substantially. While these NGOs continue to function largely unhindered, there has nevertheless been an increase in cases of alleged intimidation of NGOs aligned with the opposition parties by representatives of the secret services and tax administration.

Civil society more generally in Ukraine remains active and politically engaged, as demonstrated in November 2010 when tens of thousands of small businessmen and entrepreneurs took to the streets of Kyiv and many regional capitals to protest the government's proposed revisions to the tax code. The authorities remain tolerant of such civil society protests, which have been allowed to take place openly and without any significant interference from the police. Indeed, the Government appears to be responsive to the concerns raised by these important civil society actors, as reflected in recent statements regarding possible amendments to the proposed tax code reforms.

Annex 2 ASSESSMENT OF TRANSITION CHALLENGES

The table and the supporting text below provide an overall assessment of Transition Challenges by sector, based on Transition Report 2010. There are two separate scores for each sector, rating market structures and market-supporting institutions. Scores range from negligible, small, medium and large. "Negligible" means that the remaining challenges are minor and that the sector is well advanced in moving towards the standards of a well-functioning market economy. "Large" means that the remaining challenges are major and that this dimension of the sector is at an early stage of reform.

Ukraine: Sector transition indicators

Sectors	Market structure	Market-supporting institutions
Corporate sectors		
Agribusiness	Medium	Medium
General industry	Medium	Large
Real estate	Large	Medium
Energy		
Natural resources	Large	Large
Sustainable energy	Large	Small
Electric power	Medium	Large
Infrastructure		
Telecoms	Medium	Medium
Water and wastewater	Large	Large
Urban transport	Medium	Large
Roads	Medium	Medium
Railways	Large	Large
Financial sectors		
Banking	Medium	Medium
Insurance and financial service	Medium	Medium
MSME finance	Medium	Large
Private equity	Large	Large
Capital markets	Large	Medium

Source: Transition Report 2010.

Corporate sectors

Agribusiness

Market structure: Medium
Institutions/policies: Medium

Ukraine has seen a significant improvement in its rating since 2005. WTO accession in May 2008 was preceded by several positive policy changes regarding both tariffs as well as price liberalisation. The overall level of producer support is modest, but taxation of export-oriented sectors and considerable protection of several import competing sectors distort a number of agricultural prices along the value-chain. Ad hoc reactions to the food price crises most notably between 2007 and 2008 such as export restrictions resulted in substantial foregone revenue in the grain and oilseed sectors. WTO accession also means more import competition and pressure to improve the sector's efficiency. Yields – in particular in the grain sector – are still below international standards and a lack of storage and adequate transport infrastructure further dampens competitiveness. A moratorium on the sale of agricultural land remains in force pending the adoption of broader land laws. The warehouse receipt programme process started already in 2001, however out of court settlement procedure, and the indemnity fund need the adoption of several important land laws and will only be operational once these laws have been passed. The government operates a concessional credit programme with government interest rates subsidies for some agricultural loan products offered by commercial banks which does not overcome a key constraint of access to finance in the sector. Commercial lenders remain somewhat hesitant to extend finance to the agro-food sector. Following the latest food price hikes in the autumn of 2010 the Ukrainian government reverted to introducing export quotas for grain, maize and barley exacerbating global price pressures.

General industry

Market structure: Medium
Institutions/policies: Large

Competition in the domestic market and export opportunities increased as a result of the country's 2008 entry in the World Trade Organisation. However, due to the financial distress caused by the onset of global economic downturn and the decline in commodity prices enterprises have not been able to respond to the new opportunities and challenges by embarking on new capital expenditures to upgrade their products and processes to date. Further productivity improvements with a focus on improving value added will be a key challenge. The business environment is gradually improving with regulatory improvements to set up a new business and lessening of burden for enterprises on licensing. However, VAT refunds for exporters remain problematic. Close links between business and politics, weak corporate governance and transparency, insufficient protection of minority shareholders remain key reform priorities.

Real estate

Market structure: Large
Institutions/policies: Medium

The real estate sector developed rapidly between 2005-8 and institutional investors entered the country, but investments were mostly concentrated in the capital and other large cities, leaving regional cities largely underdeveloped. However, the global financial crisis has led to a standstill in investments in the real estate market, with industrial regions of Ukraine being affected the most. In contrast to the retail and office markets, however, there were only an insignificant number of pure speculative developments in the warehouse and logistics market, which enabled it to remain somewhat less affected by the downturn. Although the decision to co-host Euro 2012 football championship in Ukraine has increased the interest in building new hotel capacity, the hotel segment continues to be underdeveloped with only a few major hotel players present in the country. The Ukrainian property and tourism sector is characterised by a difficult and non-transparent investment climate and needs further legal and regulatory reform, better governance on local level and increased exposure to international good practice. A number of initiatives to develop a mortgage market have resulted in a strong increase in the number of mortgages and have laid the legislative and administrative groundwork for a functioning market. Transparency and land privatisation are improving but remain a serious issue. Property-related Doing Business indicators are weak, especially with regard to dealing with construction permits and registering property. Tradability of land is limited de facto.

Energy

Natural resources

Market structure: Large
Institutions/policies: Large

Ukraine is one of the most energy-intensive and energy inefficient countries in the EBRD region. It is a net importer of oil and gas, supplying less than 20 per cent of current energy consumption from domestic sources. It is an important oil and gas transit country to Europe from Russia and the Caspian region. There are six refineries on its territory but capacity utilisation is very low. The country is well endowed with coal deposits, although the sector remains substantially unreconstructed.

Some progress has been made in tackling key reform issues in the energy market, including long awaited gas tariff increases, the adoption of a new gas law and accession to the European Energy Community. Nonetheless, many key structural reform challenges remain, such as the unbundling and corporatisation of the oil and gas monopoly Naftogaz Ukraine (NAK), which remains unreformed, state–owned, vertically integrated and lacks transparency. Commercialisation and privatisation is a significant challenge in the absence of reliable information on the Company’s asset structure and revenue streams. NAK and its subsidiaries dominate the upstream oil and gas sector. Small independent companies such as JKX Oil and Gas and Cadogan have upstream oil and gas E&P interests. Oil refining and distribution are the only elements of the Ukrainian energy sector that are competitive. Ukraine’s gas pipeline system is operated by UkrTransgaz, another Naftogaz’ subsidiary.

Market supporting institutions and policies are very weak. The energy sector regulator lacks independence. In spite of recent increases, household tariffs remain below cost recovery levels and are subsidised through the budget. Coal prices in Ukraine are theoretically freely set by the market. In reality, there are many price distortions. There is very limited transparency of revenue flows, especially within the Naftogaz’ subsidiaries. The weak and uncertain regulatory and licensing regimes and weak judicial system remain key impediments to increased private participation in the sector. There has been speculation recently regarding the validity of exploration licences awarded in 2004, with some political pressure to cancel them.

Power

Market structure: Medium
Institutions/policies: Large

The power sector is legally unbundled and partly liberalised and privatised but reforms are far from being complete as evidenced by the lack of a functioning wholesale energy market and the fact that the state-owned transmission company is not corporatised. Out of 27 regional distribution companies, fourteen are majority state owned. Privatisation has been criticised for its lack of transparency and competition in retail and generation is significantly constrained by the dominance of state-owned incumbents. Implementation of market reform is clouded by political interference in the sector. Now that Ukraine signed the protocol of the accession to the Energy Community, the process should involve harmonisation of legislation with the energy sector EU acquis. Although there are plans to reform the system, the wholesale power market remains constrained by the single buyer (Energorynok) model. International power trade is de-jure de-monopolised, but de facto is still controlled by state monopolist Ukrinterenergo. The sector regulator, NERC, is formally independent, but its decisions are often undermined by ad-hoc political interventions. End-user tariffs are significantly distorted by heavy cross-subsidies from industrial to residential customers and from low cost to high cost industrial customers (flat rate across the country). Residential tariffs have been frozen for several years falling to as low as 30 per cent of the costs, according to NERC. Collection rates remain close to 100 per cent. Thermal power prices are deregulated and established through bidding to the Energomarket, although the government distorts competition. Transmission and distribution tariffs only cover short-run operating cost and some new investments but do not provide for sufficient maintenance or capital rehabilitation and modernisation projects. Furthermore, their structure does not encourage efficiency improvements. Very low energy efficiency in power generation, transmission and distribution remains a challenge.

Sustainable energy

Market structure/outcomes: Large
Institutions/policies: Small

The basic laws for energy efficiency have been in place for more than a decade but refinements and improvements of primary legislation are still necessary, because only limited results have been achieved so far. An energy efficiency (EE) agency exists but lacks adequate capacity to support a comprehensive and market driven approach to EE. Low energy tariffs, cross-subsidies and the lack of inclusion of environmental costs provided limited price signals to promote energy efficiently and to invest in renewable energy sources (RES) projects, although energy tariffs for industry have risen in the past few years. Furthermore, residential energy efficiency is held back by structural and institutional issues. The energy service company (ESCO) concept has already been piloted, but the sector remains embryonic. Energy intensity remains high in the absence of a comprehensive approach to energy conservation. New RE legislation was recently adopted, including adequate feed-in tariffs and other procedures for RE development in Ukraine, and some pilot project activities have taken place. The energy regulator NERC is currently developing secondary legislation on RE. A small share of power consumption comes from renewable energy, mostly from large hydro plants. Ukraine has signed and ratified the Kyoto Protocol as an Annex 1 Party and is one of the leaders in project-based Joint Implementation (JI) mechanism. Ukraine is also the leader in the trading of Assigned Amount Units (AAUs), which are units of country emissions quota, and in March 2009 signed the largest AAU deal to date (30 Mt with Japan). The remaining challenges are substantial nevertheless, and include the need to further develop EE institutional capacity and change the approach of the existing agency to become more market-friendly, to further increase tariffs to encourage energy savings, to test and consolidate the new legal framework for the development of renewable projects and to ensure that AAU sales proceeds are properly greened.

Infrastructure

Telecommunication

Market structure: Medium
Institutions/policies: Medium

The independence of the regulator, NCCR, is undermined by inconsistencies between different laws about who has the power to appoint NCCR commissioners. A 3G license has been awarded to the state-owned incumbent Ukrtelecom without a proper call for tender. Since the market was liberalised a number of alternative operators started offering fixed-line services, focusing predominantly on the higher-value business market, so Ukrtelecom still dominates the market. After announcing the intention to privatise Ukrtelecom a number of times, the authorities offered a majority stake in the incumbent for an auction expected to be concluded by end-December 2010. Competition is intensifying, particularly in light of the network expansions by a number of wireless local loop (WLL) operators. The penetration level in excess of 100 per cent and the price wars have left smaller mobile players struggling; majority of customers are prepaid. A new law introducing mobile number portability was signed by the president in July 2010. The Ukrtelecom’s near monopoly over the local loop and backbone network will continue to hinder market development, but broadband uptake is beginning to increase – also due to the availability of alternative fibre-optic network owned by Datacom.

Water and wastewater

Market structure: Large
Institutions/policies: Large

Municipal utility services are decentralised both in terms of ownership and decision making. Utilities are organised as municipal enterprises (semi-corporatised) with *de jure* management independence, but are *de facto* heavily dependant on the local administration. Improving financial and operational performance is a key priority, as the vast majority of local utilities continue to be loss making and utility systems remain supply driven and cost inefficient (excessive employment, large network losses, high energy costs). Access to commercial financing has improved in recent years, but only a limited number of projects were financed commercially.

Tariffs remain substantially below cost recovery and are based on outdated norms rather than actual use. Metering is rare and billing based on actual use is almost non-existent, providing little incentives for efficient use. Cross-subsidies are widespread. The governance of municipality-utility relationships needs to be improved further (e.g. service contracts are not yet common). Utility tariffs are set by municipalities and political interference is common, including from the central authorities, which needs to be addressed. Additionally the weak institutional organisation for the housing stock has a negative impact on tariff collections. Low collections combined with low tariffs requires a significantly high level of subsidies to maintain service.

Urban Transport

Market structure: Medium
Institutions/policies: Large

In urban transport, there is a mix of regulated municipally-owned operators (e.g. metro and trolley buses) and a large number of privately owned operators (e.g. mini-buses). Tariffs for the municipal operators are set by the municipalities with the government approval and are considered low by the regional standards. Cross subsidisation is a problem as there many groups of privileged users. Private operators set their own tariffs and do not receive subsidies. Municipal operators receive operating subsidies in an ad-hoc manner and, more recently, substantial capital subsidies as well. Financial performance of municipal operators is weak, partly driven by low fares and poor enforcement of fare payment and partly by high operating costs due to low productivity and efficiency. Traffic congestion is becoming an area of concern, as living standards rise and more citizens use private cars as the main mode of transport.

The key transition challenges remain in the areas of: (i) development of an adequate tariff structure providing for cost recovery for operators and no cross-subsidies within the affordability constrains; (ii) improvement in the collection rate and financials of municipal transport operators; (iii) route setting and development of public service contracts with transparency and accountability; (iv) improvement of the legal framework for municipal finance including laws regulating borrowing, security, execution and also legal and financial relationship between central government and municipalities; and (v) greater private sector participation.

Roads

Market structure: Medium
Institutions/policies: Medium

The road sector gathered reform momentum in recent years. The road sector restructuring programme was approved by the Cabinet of Ministers in February 2009, which aims to reorganise the way the road network is managed through the separation of ownership, administration and funding for state and local roads. While all materials companies were divested from Ukravtodor and are currently under private control, road construction activities have been separated from Ukravtodor and established as a joint stock company wholly owned by the state. Road sector financing has improved significantly with revenues coming from a fuel levy, vehicle license fees and transit fees. Competitive tendering procedures have been introduced for construction and large periodic maintenance works.

Transition challenges for the medium term relate to (i) further improvements in road sector financing; (ii) further restructuring of the incumbent road agency and road maintenance company; (ii) introduction of effective competition and performance based contracts in road maintenance; and (iii) development of road public-private partnership (PPP) projects.

Railways

Market structure: Large
Institutions/policies: Large

The railway sector reforms remain at an early stage. Operating and policy setting functions are not fully separated and core railway businesses (infrastructure, passenger, freight, etc.) are operated by the same state-owned entity. The long-awaited corporatisation of the national railways has not yet materialised. While an ambitious railway restructuring plan was approved by the government in 2007, it has yet to receive Parliamentary approval to start implementation. Labour restructuring is among the slowest in the EBRD countries of operation. The transition challenges remain in all key areas. At the first stage, the government needs to renew reform commitment and get parliamentary approval of legislative changes. This should be followed by creating transparent and professionally run entities focusing on the main business that would be operationally and financially sustainable.

Financial sectors

Banking

Market structure: Medium
Institutions/policies: Medium

The banking system has expanded very rapidly in the recent years, in particular, after the entry of a number of international banking groups into the market since 2004. As a result, most large banks are majority foreign-owned. These banks now need to return to normal operation after the economic and financial crisis, and then increase penetration of banking services, improve business standards, and expand lending. Two state-owned banks account for a small, but increasing, share of the market. The system remains fragmented, and consolidation is likely, as Ukraine's deep economic and financial crisis depletes system capital. The authorities were not able to establish effective channels of communication and coordination with home country supervisors before the crisis. The dependence on wholesale funding in foreign exchange combined with the *de facto* peg of the local currency to the US dollar, contributed to the dollarization of banks' assets, a significant vulnerability that materialized after the end-2008 devaluation. To respond to the crisis, the authorities have pursued a strategy of pre-emptive recapitalization of commercial banks. An important challenge is to improve governance of the nationalised institutions and avoid entrenching the state in the sector for too long.

Insurance and other financial services

Market structure: Medium
Institutions/policies: Medium

Although insurance legislation and regulation have improved in recent years, the quality of supervision and legislation remains inadequate. The size of insurance market, at 2.5 percent of GDP, is relatively large when compared to the other countries in the region, but still significantly lags developed countries. Skills and the availability of insurance products remain inadequate. The pension system is yet to undergo a major structural reform as it is largely reliant on the public pay-as-you-go pillar, and the funded element remains significantly underdeveloped. Legislation in the leasing services segment is not fully developed. The leasing services market remains small at 1.1 per cent of GDP. Non-bank consumer finance has been largely developed, although certain business practices need to be improved, in particular the standards of disclosure of effective interest rates and foreign exchange risks (where leases or loans are granted in foreign currency).

Micro, small and medium-sized enterprises

Market structure: Medium
Institutions/policies: Large

Lending is primarily provided by banks, and one specialist institution. Prior to the financial crisis, several local banks actively expanded lending to MSMEs through branches/outlets in over 250 cities of 25 regions of Ukraine. Additional mobile lending units were serving rural MSEs and some partner banks provided specialised agricultural lending. However, like elsewhere around the world, lending to MSEs suffered during the crisis as risk aversion increased. Competition among the MSE lenders needs to be enhanced in order to allow the development of efficient and easily accessible financial products, especially in rural areas and in the agriculture sector, following the crisis. Training and management capacity for MSME lending operations needs further improvement, in particular in the area of internal audit.

Private equity

Market structure: Large
Institutions/policies: Large

A viable private equity industry is gradually being established, in part through the entry of foreign private equity funds that have established offices in the country and have started sourcing professionally-structured transactions. However, both the number of market participants and the number of transactions remains low: there are only three funds dedicated to Ukraine and 14 regional fund managers also have Ukraine in their portfolios. Committed and active capital amount to 0.6 per cent of GDP and 0.4 per cent of GDP, respectively. A challenge remains in attracting new entrants into the sector, and in encouraging further funds to be supplied. Six of seven private equity investment strategies are available in the Ukrainian private equity sector. The bulk of the committed capital is focused on growth investments with buyout and infrastructure reasonably presented. Mezzanine, distressed and small capital are very minor and venture capital almost non-existent. Market institutions remain at an early stage, with corporate governance framework showing relatively low conformity with the OECD Principles of Corporate Governance. Local institutional investor participation is generally non-existent or very limited across categories from private individuals to government and sovereign funds.

Capital markets

Market structure: Large
Institutions/policies: Medium

Substantial progress has been made in securities legislation, which now shows high compliance with the International Organisation of Securities Commissions (IOSCO) principles, though effectiveness is undermined by the currently very difficult court procedures, and lack of public enforcement. The public equity market is relatively large with market capitalisation at 98 per cent of GDP, although it is highly illiquid. There is a moderate stock of tradable government securities in local currency with secondary trading. The bond markets remain underdeveloped, domestic institutional investors largely lacking, and the money markets are shallow and volatile.

Annex 3 UKRAINIAN COMPANY LAW AND CORPORATE GOVERNANCE

The principal legislation dealing with corporate governance in Ukraine is the Law on Joint Stock Companies ("JSCs Law"), approved by the Verkhovna Rada (Ukrainian Parliament) on 17 September 2008. Apart from the JSCs Law other corporate governance regulation can be found in the Civil Code, the Commercial Code and the Law on Business Associations. Further, in June 2003 a Corporate Governance Code entitled "Ukrainian Corporate Governance Principles" was enacted. These principles are intended for open joint stock companies traded on the stock market and are voluntary.

The JSCs Law came into force on 29 April 2009 and introduced substantial improvements to the corporate governance system and the legal status of minority shareholders. A two-year transitional period commenced on 29 April 2009, during which all existing joint stock companies are to be brought into compliance with the JSCs Law.

The JSCs Law requires all shares of joint stock companies to be issued in electronic form from 29 October 2010. Joint stock companies with shares issued in paper form will have to convert them into electronic shares by April 29 2011 at the latest.

Concessions

A new law on Public-Private Partnership ("PPP Law") was enacted on 31 October 2010. The PPP Law is a framework act and governs such forms of PPPs as concessions, joint ventures, production sharing and other types of activities.

The enactment of the PPP Law amends and clarifies the 1999 Law on Concessions, which was previously regarded as satisfactory in general terms but in need of further improvement in order to promote a favourable PPP regime in the country. It remains to be seen how the PPP Law will be implemented in practice, and whether any difficulties will arise in the interaction between the PPP Law and the Law on Concessions. Each of these acts is considered below.

The *Law on Concessions* clearly defines its scope of application. The provisions regulating the project agreement provide relatively clear guidance on the main issues to be covered, and yet the existence of an optional non-binding model agreement makes it sufficiently flexible for the parties to freely negotiate its terms. This law was rated as being in "medium compliance" with international standards according to the EBRD 2008 assessment of concessions laws, which examined concessions legislation in EBRD countries of operations. Amongst the areas that are still in need of improvement are: tender rules relating to the pre-selection procedure; the institutional framework and wider-government support; and the availability of instruments and mechanisms to secure lenders' interests. Nevertheless, in aggregate the Concessions Law as it stands constitutes a relatively solid legal basis for concessions.

The new PPP Law sets out and is based on a number of important principles common to the EU and other European jurisdictions, notably equal treatment, non-discrimination and fair risk allocation. Its scope of application is broad and clearly defined, in line with international standards. The legislation contains an open-ended list of applicable sectors/activities. PPP projects may have a term of between 5 and 50 years. PPP agreements are to be awarded on the basis of a tender except for certain cases defined by the law. However, the tender rules are still to be defined by the Cabinet of Ministers of Ukraine.

The PPP Law provides for other important rules and principles such as the grand-fathering clause guaranteeing the application of the regime applicable at the moment of entering into an agreement for the duration of that agreement. It introduces an investment return element, and market sensitive compensation rules in the event tariffs are set at a rate below what is economically viable for the private sector. Further, the new law specifically prohibits public sector interference in the operational activities of a private party, and provides certain guarantees and state support measures.

The PPP Law establishes and defines the powers of a new specialist PPP agency which will commence work by the end of January 2011, thus paving the way for an enhanced PPP institutional infrastructure. On 7 February 2011, the Cabinet of Ministers approved the Draft Decree of the President of Ukraine "On Determination of the Authorised Agency with respect to the Issues of Public-Private Partnership in Ukraine". The Draft Decree was then submitted for signing to the Administration of the President of Ukraine. According to the Draft Decree, the Ministry of the Economic Development and Trade of Ukraine was named as the Authorised Agency for the purposes of the PPP law.

Insolvency

At present, bankruptcy and insolvency in Ukraine are primarily governed by the "Law on Restoring Debtor's Solvency and Declaring a Debtor Bankrupt" of 14 May 1992 (**"Insolvency Law"**). As reflected in the graph below, the EBRD's 2009 Insolvency Sector Assessment found that the Insolvency Law is in "low compliance" with the EBRD's Core Principles for an Insolvency Law Regime, based on five core areas most relevant to the sector. These results are in line with assessments conducted by other international organisations, which have measured Ukraine's insolvency legislation against international insolvency standards, such as those set by the IMF, the World Bank, the Asian Development Bank and the United Nations Commission on International Trade Law (UNCITRAL).

As the EBRD assessment has revealed, the Insolvency Law is still deficient in virtually all 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. 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. In addition, the law fails to provide for the timely delivery of property of the debtor to the bankruptcy manager or for the effective avoidance of suspicious pre-bankruptcy transactions.

The above deficiencies are 'critical' or 'threshold' deficiencies in that they are imperative to the basic functioning of a proper insolvency law. The Insolvency Law has several other important shortcomings. There are inadequate requirements for the qualification, appointment, review and replacement of an insolvency office holder; there are no provisions for set-off; and, there are insufficient sanctions for failure to comply with the law. The Insolvency Law remains weak as regards commencement of proceedings (for instance, there is no provision for a balance sheet insolvency test or anticipatory insolvency). Furthermore, the law does not provide for a mechanism to assist creditors to establish insolvency.

To date there are few professional work standards or ethical rules for insolvency office holders. Supervisory, regulatory and disciplinary provisions applicable to insolvency office holders are substandard.

The Insolvency Law contains some positive elements. There is a formal requirement for a speedy hearing and determination of proceedings. There is provision for pre-packaged restructuring, both by means of bankruptcy to extinguish debts and through reorganisation to restructure the company. However, the results of the EBRD 2004 Legal Indicator Survey, which measured the "effectiveness" of insolvency regimes (i.e. how laws work in practice), suggests that the practical application of the Insolvency Law is expensive, slow and unduly complex. In addition, the results of the survey show that the predictability and competence of judges hearing bankruptcy cases is unreliable.

Judicial Sector

Ukraine's judicial system consists of the Constitutional Court, courts of general jurisdiction, and specialised administrative and commercial courts.

Important judgements are generally published and accessible to practitioners and the public, affording the legal system a certain level of transparency. There is a right of appeal from first-instance court decisions, and a right of judicial review of administrative action. There are constitutional and other formal guarantees of judicial independence. However, although Ukrainian laws provide a legislative framework for an independent judicial system, concerns persists about lack of impartiality and independence of the courts. Corruption is perceived to be one of the main obstacles to a fully effective judiciary in the country. Ukraine ranked 146th among the 180 surveyed countries in the Transparency International 2009 Corruption Perceptions Index. Further, in the EBRD – World Bank Business Environment and Enterprise Performance Survey 2008-2009 (BEEPS), only 19 per cent of the participants believed that the courts were fair and uncorrupted. Further, only 17 per cent of business respondents considered the court system to be fast.

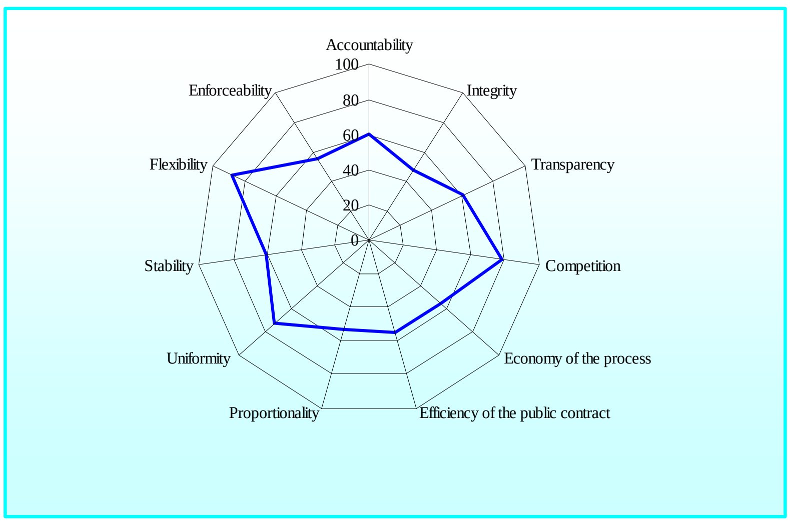
In what may prove to be a positive development, the Judiciary Act was amended in 2010 to provide that certain decisions of the Supreme Court are binding on courts below and constitute a formal source of generally applicable law. This reform was part of a suite of amendments which in fact limited the jurisdiction of the Supreme Court in many respects, devolving greater powers to the higher specialised courts (e.g. the Higher Commercial Court). However, one important function still performed by the Supreme Court is to hear cases which concern divergent interpretations of law by courts below. In such matters, a decision of the Supreme Court is formally binding on all courts and administrative authorities in Ukraine. The end result of this reform may be greater uniformity in judicial decision-making.

Public Procurement

Public procurement in Ukraine is regulated by the Public Procurement Law ("PPL") which entered into force on 1 July 2010. The PPL covers procurement by national and local government and state-owned companies, but does not include specific rules for the utilities sector. PPPs and Concessions are regulated by separate legislation.

The EBRD 2010 Public Procurement Legal Frameworks Assessment results show that the Ukrainian public procurement framework is in low overall compliance with international standards and best practice, both in relation to integrity and efficiency dimensions. The low marks for integrity and transparency indicators suggest that the procurement process may be affected by corruption. The PPL is relatively uniform and adheres to the principle of fair competition, however it is not so strong in relation to integrity, transparency, and accountability features (see chart below). In addition, the evident lack of legal stability may lead to frustration among the stakeholders. In general, the PPL leaves room for inefficiencies and irregularities to occur in the public procurement processes.

Quality of public procurement legal framework – Ukraine (2010)



Note: The chart shows the score for comprehensiveness of national PP laws. The scores have been calculated on the basis of a legislation questionnaire, based on the EBRD Core Principles for an Efficient Public Procurement Legal Framework http://www.ebrd.com/ pages/ sector/ legal/procurement/ core_principles. shtml

Total scores are presented as a percentage, with 100 per cent representing the optimal score for these benchmark indicators.

Source: EBRD Public Procurement Legal Frameworks Assessment 2010

Secured Transactions

In the last couple of years, Ukraine has undertaken considerable reforms in the field of commercial law, in particular 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, have fundamentally changed the conditions in which commercial transactions take place. Despite some confusion and uncertainty (not unusual in transition economies), these changes have largely been positive. The financial crisis, however, has hit Ukraine's real estate and mortgage finance particularly hard and this is unfortunately demonstrating the weaknesses that exist in the institutions surrounding debt enforcement.

Security rights over movable assets in Ukraine are governed by the Law on Securing Creditor's Claims and Registration of Encumbrances of 23 December 2003 (Securing Creditor's Claims Law), which entered into force on 1 January 2004. The Law on Pledge of 2 October 1992 remains in force but is now of more limited relevance since it will only apply for matters not covered by the 2003 Law on Securing Creditor's Claims (although precisely 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. To be effective against third parties, they require registration in the State Register of Encumbrances over Movable Property. This register, which replaces the State Register of Pledges of Movable Property, commenced operation in August 2004. All encumbrances entered into prior to 1 January 2004 have been automatically transferred to the new Register. The main weaknesses of the regime lie with the 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, remain uncertain, despite fairly liberal provisions in the law, and legal advisers are usually ambivalent in this respect. Also, there remains significant uncertainty on successfully taking and enforcing security over bank accounts. The Securing Creditor's Claims Law also provides for extra-judicial enforcement in the form of transfer of ownership of collateral to the creditor, the sale of the collateral directly by the creditor, the assignment of pledged rights to the creditor or the transfer of funds. However, the practical experience to date in using these mechanisms has not been positive.

Security rights over immovable property (mortgages) are governed by the Law on Mortgage of 5 June 2003 ("Mortgage Law") and the relevant provisions of the Civil Code. Mortgages 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 still applies; it can only be mortgaged to banks as mortgage creditors. Mortgage rights enjoy priority in the mortgaged property from the moment of their 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 by law automatic statutory priority.

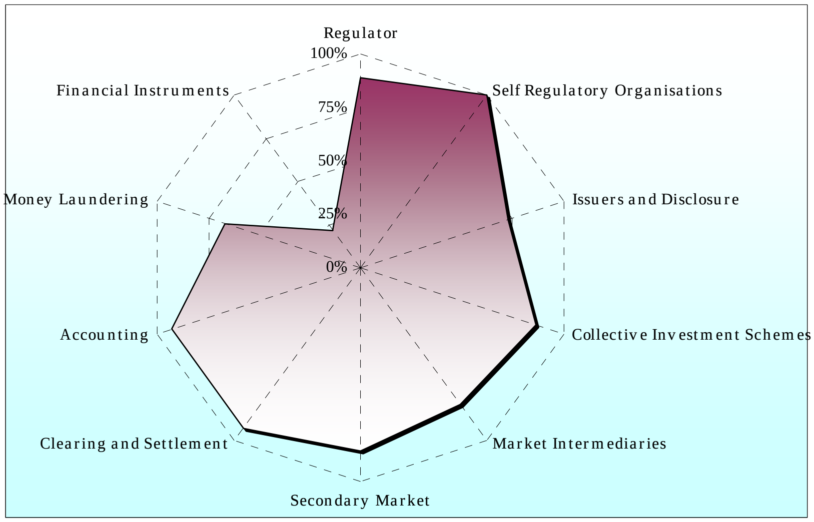
In cases of mortgagor default, mortgage rights can technically be enforced without involvement of a court by a direct sale or by a public auction, depending on the provisions of the mortgage agreement or other agreement concluded subsequently. The mortgage creditor can approach the State Execution Agency, 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.

During the booming real estate market up until 2008, enforcement was reported to take usually up to 6 months, and the sale proceeds corresponded to the asset's market price. Since then, however, lenders have been very unhappy with the way they are able to enforce their rights (also due to the fact that the real estate market has crashed, making the value of collateral significantly lower).

Securities Markets

The basic legislation regulating the securities markets is the Law on Securities and the Stock Market enacted on 23 February 2006. The Law regulates the placement and circulation of securities and the conduct of professional activities in the stock market and aims to ensure effective and transparent stock market activities.

Quality of securities market legislation – Ukraine (2007)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations.* The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2007

In 2007, the EBRD benchmarked the securities markets legislation of Ukraine against the "Objectives and Principles of Securities Regulation" published by IOSCO. The assessment showed that the national framework is in "high compliance" with international standards (see chart above), but it lacks comprehensive regulation on bonds and derivatives. In order to understand how securities markets legislation works in practice, in the same year the EBRD undertook a Legal Indicator Survey asking practitioners in the region to comment on a hypothetical case study. The Survey concentrated on effectiveness of prospectus disclosure requirements, private and public enforcement mechanisms and authority of the market regulator. The Survey revealed that IPOs are not common in Ukraine. Information included in the prospectus can be incomplete. Private enforcement mechanisms allow for limited course of action and they are generally lengthy and burdensome. Finally the capacity of courts, regulator and prosecutors in investigating complex securities cases needed to be improved.
As a result, national authorities should consider implementing some specific actions in order to improve the capacity of institutions in effectively implementing the legislation.

Annex 4 ENVIRONMENTAL AND SOCIAL DEVELOPMENTS

Legislative and regulatory framework for environmental issues

The Ukrainian government recognises the importance of addressing country's environmental problems and has developed over time a legal and regulatory framework for this purpose. A number of environmental protection policies, programmes and concepts were prepared. These set out strategic directions of sustainable development implementation at a national level and include among others the Comprehensive Programme on National Implementation of the Decisions of the World Summit on Sustainable Development 2003-2015, National Program for Forests of Ukraine 2010-2015, Concept of the National Environmental Policy of Ukraine till 2020, Concept of the National Program on Conservation of Biodiversity for 2005-2025. The National Environmental Policy until 2020 was adopted by law in December 2010, and the implementing National Action Plan on the Protection of the Natural Environment is under development. Environmental considerations have also been introduced into the sector development programmes 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.

There have been a number of legislative changes in the environmental sphere since the previous country strategy (2007) for Ukraine. For example, the National Agency for Environmental Investments, new governmental body responsible for UNFCCC and Kyoto Protocol implementation, was established in 2008. Its key current responsibility is in setting up a regulative framework for Joint Implementation mechanism under Kyoto Protocol and green investments scheme. The latter was introduced by the Law on Green Investments in 2009 oriented to support energy efficiency and renewable sources investments that reduce GHG emissions and thus can generate carbon credits. The objective of the scheme is in developing the national carbon market in Ukraine.

Among other legal developments it is worth mentioning a new set of laws and regulations in the area of Genetically Modified Organisms (GMO) production, supply chain, transportation and use adopted in 2009 to ensure biological and genetic security and distribution of responsibilities for their control. Several changes in the Law on Protected Areas were made in 2010 to introduce stricter bans on any activities in the boundaries of protected areas. A number of waste related laws were amended in 2010 aiming at the implementation of waste segregation, recycling, prevention of unauthorized litter disposal and increases in penalties for non-compliance with waste regulations.

However, it is critical for Ukraine to ensure that sufficient political will, financial resources and adequate mechanisms is generated to ensure the effective implementation of these commitments. It is necessary to further strengthen the legal and regulatory framework for the environment with an emphasis on preventive measures as well as building effective compliance and enforcement programmes. At the business level the government should incentivise investments in environmental management systems, implementation of technology-based standards for pollution control, as e.g. Best Available Techniques under EU IPPC legislation, adaptation of better environmental indicators and strengthening of their monitoring.

International cooperation in environmental sphere

Overall, Ukraine is party to some 55 international conventions and has approximately 70 multilateral and bilateral environmental agreements as per Ministry of Environmental protection. As a member of United Nations Economic Commission for Europe (UNECE) since 1947 Ukraine has ratified four out of five UNECE environmental conventions: Long-Range Transboundary Air Pollution, Environmental Impact Assessment in a Transboundary Context (Espoo Convention), Protection and Use of Transboundary Watercourses and International Lakes, Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters (Aarhus Convention). Ukraine has not yet ratified the UNECE Convention on Transboundary Effects of Industrial Accidents.

International environmental protocols and conventions recently adopted by Ukraine include the European Landscape Convention (Florence Convention) in 2006, the Stockholm Convention on Persistent Organic Pollutants in 2007, and the Black Sea Biodiversity and Landscape Conservation Protocol to the Convention on the Protection of the Black Sea against Pollution in 2008.

Ukraine is a priority partner country within the ENP Initiative of the EU. At the Paris Summit in September 2008 an agreement was reached to start negotiations on an EU-Ukraine Association Agreement, and an EU-Ukraine Summit is to take place at the end of November 2010. As part of environmental objectives of ENP’s Action Plan, Ukraine takes part in the Danube-Black Sea Task Force to implement a transboundary approach to water management, the Eastern European, Caucasus and Central Asia component of the EU Water Initiative and the Joint Ukraine-EU Working Group on Climate Change. The new Eastern Partnership initiative aims at additionally enhancing closer cooperation with Ukraine in such areas as good governance and energy. However, the 2009 assessment of the Action Plan implementation concludes that strengthening of administrative capacity building in the environment field and provision of financial mechanisms remains a challenge.

Public access to environmental information

Ukraine ratified both the Aarhus Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters and the Espoo Convention on Environmental Impact Assessment (EIA) in a Transboundary Context back in 1999. However, the challenges in implementing their provisions at national level remain. The Aarhus Center for environmental information was established in 1999, but the country struggles to set up adequate practical mechanisms for effective access to information and public participation in environmental matters. As of September 2010, out of 25 regional branches of the Ministry of environmental protection only 13 agreed to establish online public access to EIA that was recommended by the Aarhus Centre.

The European Commission (EC) financed project “Support to Ukraine to implement the Espoo and Aarhus Conventions” was first presented to the public at the meeting of the Public Council by the Ministry of Environmental Protection of Ukraine in December 2009. Its objective was to provide support to Ukraine in its efforts to comply with its obligations under both Conventions by making recommendations to the Government of Ukraine. During its course, the project provided a detailed assessment of the legal, administrative and procedural aspects of the implementation of the Espoo and Aarhus Conventions in Ukraine. Four training seminars were also organised for local and central environmental authorities and regional Aarhus Centers.

The Final report on the project's results and outputs was presented in July 2010 in Kyiv at the meeting with DG Environment, DG RELEX of the EC and the EU Delegation in Ukraine. The project experts prepared the Draft Order of the Cabinet of Ministers of Ukraine on Taking into Account of Public Opinion in Environmental Decision-Making process and forwarded it to the Ministry of Environment for further consideration by the Ministry and public consultations.

Another outstanding challenge for Ukraine is in development and implementation of clear mechanisms for Strategic Environmental Assessment (SEA) of plans, programmes, and draft laws of the Government. Ukraine still did not ratify the SEA Protocol (2003) to the Espoo Convention that requires its signatory parties to evaluate the environmental consequences of their official draft plans and programmes, thus enabling extensive public participation in government decision-making in numerous development sectors.

NGOs and civil society

Over 500 civil environmental organisations are active in Ukraine, as per UNECE's 2nd Environmental Performance Review for Ukraine (2007). Most of them aim at environmental protection on regional and local levels, but there are a number of large ones operating at national and international levels. They have significant importance in promoting environmental education and working with society to raise awareness over existing issues, as well as conducting necessary research and participating in policy making through public consultations process. There is still a need for improvements to be undertaken by Ukraine in future to ensure effective access to information and public participation in environmental matters. EBRD's relationship with Ukrainian NGOs remains strong and effective as they represent an important monitoring mechanism of the Bank's policies implementation.

Climate change mitigation and adaptation

Ukraine ratified the Kyoto Protocol to the UN Framework Convention on Climate Change in April 2004, and associated with the Copenhagen Accord on Climate Change in April 2010. In recent years Ukrainian climate change mitigation approach focused primarily on two issues: use of Joint Implementation (JI) and trading of emissions surplus AAUs. In the case of joint implementation, the regulatory rules were changing several times by the Government, resulting in barriers in the use of this financial mechanism under Kyoto Protocol. National Agency for Environmental Investments has been recently made responsible to clarify the JI regulative framework. The Government made significant preparations to start carbon emissions trading, but the uncertainty still remains with regard to the use of funds raised from emission trading.

Current UN IPCC climate models predict that Ukraine will experience increases in mean annual temperatures of 1-2˚ C by the middle of the 21st century, together with decreases in precipitation of up to 10 per cent in the south and slight increases in the north by the end of the century. These changes are expected to have significant impacts on agriculture, forestry, coastal zones and water resources. In addition, sea level rise is a real threat to coastal zones and coastal infrastructure. The Black Sea level understood to be rising at a rate of 1.5 mm per year.

Under these scenarios, it is possible that agricultural production could be negatively affected, with a greater need for irrigation in southern Ukraine. This will intensify the need for agricultural reforms and for investment in improved production techniques in order to maintain and improve productivity. These factors should be considered in investments that depend upon the long-term availability of agricultural commodities. Similarly, forests may be affected (species composition, productivity and stability of forests) and this may require greater attention to measures such as protection against pests and diseases, and the use of wood species best suited to changing climate conditions.

Coastal zones and coastal infrastructure are vulnerable to sea level rise and changing erosion patterns and these issues should be considered in investments in port and other coastal infrastructure, which are critical for Ukraine's transport networks and trading links with the global economy. Water resources may be affected by shifts in precipitation and peak temperatures, which should be considered in the planning of water supply systems and in investments in water-intensive industries (agriprocessing, paper & pulp, chemical manufacturing etc). In addition hydropower generation may be affected by changes in river hydrology.

Therefore, strategic objectives in the area of climate change mitigation will need to focus on improving the quality of national GHG inventory reporting, setting transparent and clear rules for JI projects, ensuring transparent emission trading mechanisms with clear conditions on the use of funds gained, developing regional strategies on mitigation of climate change impacts in consultation with local authorities, developing plans for adaptation to climate change, and implementing sectoral programmes on energy efficiency.

EBRD will consider climate change mitigation and adaptation issues in projects appraised and, where appropriate, will work with clients to address issues and opportunities, particularly in sectors such as forestry, agriculture, infrastructure, natural resources, power and energy sectors that are potentially to be affected in Ukraine. In addition, EBRD will continue to participate in carbon finance projects under Kyoto trading mechanisms or voluntary schemes.

Nuclear safety

Nuclear safety remains to be a priority area of Bank's work in the country, with the EBRD-managed CSF helping the country to enhance safety of the Chernobyl shelter through the stabilisation programme and the construction of a NSC. The contract for construction of a new shelter to be built around the sarcophagus was awarded in September 2007, and construction has begun, with the ultimate goal of its commissioning in 2014. Additionally, the Bank is currently undertaking a strategic review of the safety upgrade programme for existing Ukraine's NPPs that includes modernisation of 15 nuclear reactors to internationally recognised nuclear safety level. 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.

Labour and occupational health and safety issues

Ukraine is a member of the International Labour Organisation (ILO) and has ratified 55 ILO Conventions, including the 8 core Conventions. However, their practical implementation is not always compliant with ILO's standards. Thus, Ukrainian legislation allows under-18s to perform hazardous work under certain circumstances. The ILO's Committee of Experts (2008) has raised concerns that the legislative controls on this work do not comply with C138 (Minimum Age Convention, 1973). According to the Committee of Experts, children as young as 14 years may perform hazardous work in connection with vocational training. According to the International Trade Union Confederation (2008), there is a general lack of good faith bargaining, and employers often refuse to enter into collective bargaining.

Labour law reforms have been pending in Ukraine since 2003, after ILO's recommendations to update current Labour Code, which dates back to 1971. The ILO received a new draft of the proposed Code at the end of 2008. The draft since then was with the Parliament of Ukraine for final reading, but in November 2010 the Parliament speaker announced postponing decision on the Labour Code until 2011. There is a lot of criticism of the draft, including for such changes as increase of a working week from 40 to 48 hours, legalizing video monitoring at workplaces, shortening notification period to 2 weeks for redundancies in small companies (fewer than 20 employees) among other changes.

The EU Progress Report (2008) on ENP's implementation in Ukraine notes that the country has benefited from ILO technical assistance to build the capacity of its labour inspectorate, but further work is necessary to reinforce the administrative capacity of the Ministry of Labour and Social Policy. There are known enforcement issues in relation to health and safety, minimum wage obligations, and child labour.

With regard to occupational health and safety (OHS) a high rate of workplace injuries and fatalities, especially in mining and heavy industries, prevails as key concern in all sectors of Ukraine. As per survey, undertaken by ILO in March 2010 for Ukraine, the most serious injuries in manufacturing sector were related to burns, exposure to noise, irritants, dust and chemicals. Looking at hazards representing serious safety problems in different sectors the survey showed that being struck by objects, lifting and transport of materials were the three most common problems in primary production workplaces. Problems of concern in manufacturing included electrical hazards, fire risk, lifting and transport of materials. According to the survey, the construction and energy-related industries experienced more serious problems than any other.

Organisational issues can also have an effect on safety, health and well-being of employees. Over all sectors the most common organisational problems cited in the survey were job security, work overload, workplace design, eating facilities and sanitary facilities. Job security was among the most important concerns across all industries. Considering that 73.2 per cent of the workplaces surveyed had reduced their number of workers over the last three years, it is most understandable that workers are seriously concerned about job security.

The Bank adopts a rigorous approach to labour and working conditions issues. The application of a specific Performance Requirement 2 under 2008 E&S Policy covers assessment of such areas as labour conditions, fair wages, non-discrimination, gender equality, retrenchment policies, trade unions and collective bargaining practices.

Gender Issues

Ukraine ranks 44th out of 138 countries on the Gender Inequality Index in the UNDP's Human Development Report 2010, as compared to its Human Development Index rating where it ranks 69th out of 169 countries with data. Women have faced barriers to increased participation in the labour market through discrimination in recruitment and the loss of state support for child care.

Although transition has democratised gender relations in many ways, women and men have both faced pressures during the transition period. In particular, women have faced greater difficulties as a result of their reproductive and family roles and experience increased barriers to participation in the labour market. High levels of unemployment that followed transition undermined men's earning potential, leading to lower levels of self-esteem that are thought to have exacerbated levels of alcoholism and suicide for men. Other problems have included poor maternal health, limited political representation, gender-based violence and a dramatic increase in trafficking. The rural-urban divide has an important bearing on gender equality.

Rural women experience more barriers to accessing health services, employment and entrepreneurial opportunity, and there are key regional disparities in levels of unemployment and women's employment rates. Women belonging to particular ethnic groups may face "double-discrimination," including Roma, Crimean Tatars and persons of non-Slavic appearance.

There have been some positive developments during the transition period with respect to gender equality, as the growth rate of businesses managed by women is now higher than most other countries in the region (after Poland and Latvia). In addition, the strengthening of civil society since transition has raised awareness of previously ignored social issues and problems, including women's rights and violence against women.

Annex 5 KEY LESSONS LEARNED FROM PREVIOUS STRATEGY PERIOD (Prepared by the Evaluation Department)

Energy and Infrastructure

Power and Energy – The Ukrainian Energy Services Company - UkrEsco[2] received an EBRD loan in 1998 which was coupled with a substantial EU-TACIS grant. This combination proved to be *Highly Successful* in triggering the development of effective mechanisms for implementing energy saving projects in Ukraine to the benefit of both small and medium sized enterprises and public sector institutions. A *lesson learnt* from the project with UkrEsco is that start-up funding for ESCOs may be required initially, but should be reconsidered over the project implementation (PEX08-331).

Transport - The Railway Development project made good to excellent achievements for instance in its track maintenance component. The corporate reform process at Ukrainian railways however unfolded considerably slower than expected. A *lesson learnt* from the railway project is that environmental objectives are at times set at too high a level. In this case the EAP was to be designed within the overall aim of meeting EU standards, even though it was not clear that this was either affordable or achievable for the client (PEX07-307).

Enterprises

Agribusiness - This sub-sector traditionally accounts for a large share of EBRD activities in the Corporate Sector, some 16 per cent of the Bank's portfolio have been invested here since 2005. The Bank's operation with the tomato-processing company **Chumak** was evaluated in 2008. The project had a good demonstration effect on the industry for a successful restructuring of a formerly state owned production unit. In addition, strong impacts on the regional economy were achieved through the actively cultivated backward linkages to local suppliers.

Manufacturing – Recent Bank investments include loans to **Bosch Service**, Uksnab and ArcelorMittal and have all seen partial success as per recently conducted evaluations by Evaluation Department. The investment with **ArcelorMittal Kryviy Rih (AMKR**) for instance has achieved the objectives related to increased capacity utilisation, corporate restructuring and market expansion. Conversely, it fell short of its energy efficiency objectives; and saw an *Unsatisfactory* environmental performance. A ***lesson learnt*** from the AMKR project is the limited scope for energy efficiency gains at Soviet-style steel mills, as those were built to use cheap energy from external supplies and are not designed to capture and recycle waste gases (PE09-448).

Financial Institutions

[1] See Annex 5 for EvD's key lessons learned from previous strategy period.

Banking – Among the priorities of the last Country Strategy the Bank aimed at encouraging foreign investment and developing local currency financing instruments. Before the crisis, the transition impact potential of the FI projects deteriorated along with their additionality. Thus, during the period between September 2007 and end-2008, 20 per cent of FI projects were rated ‘Satisfactory.’ However, this was reversed as the EBRD engaged in crisis mitigation activities in the sector starting in early. Only one recent FI project was given ‘Satisfactory’ transition impact rating since the onset of the crisis. A large TC programme funded by the EBRD Shareholder Special Fund (ESSF) was approved in 2009.[3]

MSME and Non-Bank Financial Institutions – The Bank’s operation with **OTP Bank**[4] had two components: the *Mortgage Facility* provided long term funding to support mortgage lending in general and the transition from a predominantly corporate bank into a universal bank. The *Subordinated Loan* component was to support market expansion and competition in SME lending by raising tier II capital. A recent evaluation saw the achievement of original objectives largely prevented by the ‘new market reality’, concluding that: *EBRD capital support is now about helping OTPU sustain losses from deteriorating assets, rather than the objective at entry.* A ***lesson learnt*** from the project with OTP is to establish sub-loan reporting from the outset as this will facilitate comparison between performance of loans under the EBRD’s criteria compared to those of the client bank (PE09-467).

[3] No evaluation report is available for banking sector projects in Ukraine since 2007, the time of the last Country Strategy. Therefore, no new lessons are described here.

[4] The successor entity to Raiffeisenbank Ukraine, a long standing customer of EBRD.

Annex 6 EBRD SUSTAINABLE ENERGY INITIATIVE

Energy efficiency will be a cross-sector priority of the Bank for the next strategy period. Ukraine is one of the most energy intensive countries in the world. It is only one-third as energy efficient as an average EU country. Because of this, Ukraine has an enormous potential for energy efficiency improvements, in every sector of the economy – industrial production, power generation, households, transport and agriculture.

Ukraine is facing an important challenge in ensuring that its resurgent economic growth will be compatible with the challenges posed by the move towards lower-carbon economic activity in order to mitigate climate change. Ukraine's energy intensity is 2.5 times that of Germany, while its CO2 emissions intensity is almost three times that of Germany. Considering the future growth in energy demand by a population and enterprises, it is clear that a significant effort is called for to achieve long-term sustainable growth in energy supply and demand.

The Bank has a long history of sustainable energy finance provision in Ukraine, which is in line with its mandate and the government's priorities and long-term strategy. The overall potential of the Bank's interventions is in some cases dependent on changes to regulatory and legislative frameworks being implemented. The Bank is already supporting these changes through the provision of technical assistance where the government has indicated an interest in pursuing them.

On 10 June 2009, the Bank and the Government of Ukraine signed a Sustainable Energy Action Plan (SEAP) in Kyiv, which provides the scope to further expand the EBRD activity and impact in the area of sustainable energy. 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. This should help strengthen the country's energy security, improve industrial competitiveness and reduce energy bills for Ukrainian people.

The main areas of activities and sector focus will be as follows:

- **Industry –** the Bank will scale up sustainable energy activities in the corporate sector primarily through the expansion and re-positioning of the current Industrial Energy Efficiency Programme. The Bank will use a sectoral approach with the objective to enhance competitiveness of corporate enterprises through the optimal use of resources, technology innovation, and the introduction of best practice and improvements to the energy management practices of the clients. The Bank will also pursue land-mark transactions in e.g. the steel sector, to achieve wide demonstration effects. It will, where appropriate, utilise climate finance to overcome clearly identified barriers to investment in energy efficiency. The Bank will also consider the provision of assistance to the business and to the Government of Ukraine in developing an efficient system for transfer of modern energy efficient and climate-friendly technologies.

- **Sustainable Energy Financing Facilities –** the Bank will enhance current and launch new activities with a number of financial intermediaries in order to be able to effectively reach SMEs, small-scale renewable developers, and residential clients. The Bank will support the Ministry of Housing and Communal services on establishing enabling legislation and raising awareness to facilitate energy efficiency investments in the residential sector, and will consider supporting other relevant parts of the government, where appropriate, to further broaden the reach of these facilities.
- **Cleaner Energy Supply** - the Bank will increase the drive for high-efficiency rehabilitation and modernisation in the Ukraine's energy sector, which has enormous potential for energy efficiency improvements during production, transmission and distribution. Through available TA programmes, the Bank will support its clients to identify the most appropriate rehabilitation investment programmes that will extend the lifetime of main equipment, improve energy efficiency and overall performance as well as reduce environmental impacts. The Bank will also offer support to the government to develop and implement the long-term approach to power supply rehabilitation and investment that is necessary to ensure that the energy supply system of Ukraine will be meeting the challenge of an increasingly carbon-constrained world.
- **Renewable Energy** - there is significant potential for Bank investment in the renewables sector, especially in small hydro and wind energy installations. The Bank acknowledges its interest in exploring financing opportunities for renewable energy projects and will continue to provide comprehensive support for the development of the regulatory environment, and for investments in the sector. To assist Ukraine to realise its large renewable energy potential, the Bank, with support from the Global Environment Facility and the CTF, has launched the USELF, which aims to provide development support and debt finance to renewable energy projects. The Facility comprises an amount of up to EUR 50 million for financing projects together with EUR 20 million concessional co-financing from the CTF and a technical assistance component of EUR 6 million funded from a grant of the Global Environment Facility. Beyond this facility, the Bank will continue to consider individual landmark transactions into e.g. large wind farms, which will demonstrate to international and local investors the viability of renewable energy supply in Ukraine. A particular focus will be put on developing the biomass sector. In the medium term, the Bank is considering the preparation of a TC programme on biomass market development, which could examine the market in Ukraine and analyse in detail the areas of resource potential, project demand and commercial barriers, and explore financing possibilities. On the financial side, the biomass sector (with a large potential but many small and fragmented projects) could be supported through a dedicated Biomass Energy Financing Facility aimed at providing both financing and specialised technical support for project developers (one stop shop). This will depend on the Government of Ukraine providing an adequate regulatory framework which will allow these projects to demonstrate their economic viability.
- **Municipal Infrastructure and Buildings –** The Bank will continue development of municipal infrastructure projects with significant energy efficiency scope in respect of district heating, water supply and waste water, solid waste, public transport, and energy efficiency improvement of residential and administrative buildings. The Bank will continue supporting the Ukrainian Government in the development of commercial,

organisational and financial structures for financing energy efficiency in public and residential buildings through its dedicated TA programmes. It will make the best possible use of the resources of the E5P programme which are expected to become available to support municipal investments in Ukraine in the near future.

- **Carbon Finance –** the Bank will continue to provide a comprehensive support to the National Environmental Investment Agency of Ukraine to further increase the potential for carbon financing in Ukraine, including international emission trading supported by Green Investment Schemes as well as development of new financing instruments to support Joint Implementation projects.

Annex 7 TAM/BAS ACTIVITY IN UKRAINE

The TAM/BAS Programme supports economic transition by achieving enterprise change in potentially viable micro, small and medium enterprises (MSMEs) and contributing to the development of sustainable infrastructures of local business advisory services in the EBRD countries of operations.

1. TAM/BAS in Ukraine

Previous TAM experience
Since inception in 1997, the TAM Programme in Ukraine has undertaken 63 projects utilizing EUR 3.8 million in donor funding. The main donors have been the EU, Japan, Italy, Canada, Finland and Germany, with additional bilateral funding from Taipei China, Denmark, the Netherlands, Austria, Greece, Switzerland, the UK and Belgium. Companies that TAM has assisted in Ukraine have an average of 600 employees and an average turnover of USD 20 million. The projects have been distributed throughout Ukraine, assisting enterprises in the food processing, retail trade, furniture and related products manufacturing sectors. There are also on-going TAM energy efficiency projects, funded by Germany.

Previous BAS experience
Since inception in 2010, BAS Ukraine has received a total of EUR 0.7 million in donor funding. The main donor has been the ESSF. The Programme has undertaken a total of 40 projects with MSMEs, engaging 35 local consultants. About 65 per cent of the projects have been implemented with enterprises with less than 50 employees. Industries supported include construction, metals/machinery manufacturing and IT sectors. The BAS Programme in Ukraine has also undertaken a number of market development activities geared towards the development of local business advisory services market.

2. MSME and Consulting sector in Ukraine

The MSME sector

In 2009 the share of small-sized enterprises totalled to 93.7 per cent out of total enterprises with medium-sized enterprises being only 5.8 per cent. With regard to employment, the numbers are more balanced: Small enterprises provide 26 per cent of total employment in the economy, medium-sized enterprises 34.5 per cent and large enterprises 39.5 per cent.

The business environment in Ukraine remains unfavourable, according to the World Bank's Doing Business Report 2010 Ukraine ranks 145th out of 183 countries surveyed in its Ease of Doing Business Index. The global financial crisis adversely affected the Ukrainian banking sector. The lack of access to finance continues to constrain the development of the MSME sector in Ukraine.

A variety of business associations advocate the needs of the MSME sector in Ukraine. Overall, the business support infrastructure requires further upgrading in order to help Ukrainian MSMEs to meet new economic challenges.

Government support to the MSME sector
The Ukrainian authorities have yet to provide a coherent programme to assist MSMEs with core business skills/values of the market economy. The government has been focusing on providing access to finance and some basic training. Government has attempted to simplify the process of obtaining permits and licenses, but still many activities need licenses, and time/cost for obtaining them remains high. At present, the state policy focuses on the increase in the quality of public regulation of MSME which leads to the improvement of the regulatory and legislative framework for MSMEs and the financial environment.

Donor support to the MSME and consultancy sector
In addition to the EBRD, a variety of international donors actively support the development of the Ukrainian MSME sector. US Agency for International Development (USAID), the EC and the Canadian International Development Agency (CIDA) have provided extensive assistance in building the government's and SME stakeholders' capacities in order to support the development of the sector. IFC primarily focuses on the improvement of the business environment. Norway provides support to the development of social corporate responsibility within the SME sector. A number of international donors such as Germany (Gesellschaft für Technische Zusammenarbeit), the Netherlands, Denmark and Finland also provide direct assistance to Ukrainian MSMEs supporting agricultural production and MSMEs development in rural areas.

The consultancy market
The local consultancy market in Ukraine was initially funded by international donor yet consultants have gradually broadened their range of services to focus more on private companies' demand. The quality and supply of consulting services are at a basic level and concentrated in Kiev. Yet the consultancy market remains highly fragmented and relatively weak and needs support to professionalize and consolidate the sector.

MSME demand for advisory services is present in the capital, but is still focused on the basic advisory services. There is a need to promote more complex consultancy services having lasting effect on the companies' performance.

3. TAM/BAS continuation in Ukraine

Continuation of TAM

In light of weak management practices in mid-sized firms in Ukraine, business advice from international experts is highly relevant. Given the EBRD's desire to increase its level of engagement with mid-sized firms in Ukraine, it is important to develop the TAM Programme and investigate new approaches to improving management in mid-sized firms. In cooperation with the Chief Economist Office, TAM plans to carry out a randomized impact assessment study assessing the impact of TAM's advisory services on firm productivity and profitability, employment growth, and efficient use of energy. The design of the study will make an explicit comparison with a more standard management intervention provided by a commercial consulting firm. In addition, enterprises with no external advisors will serve as the control group.

TAM will continue to work with companies on balance sheet restructuring, improving energy efficiency, building an export orientation, and improving operating efficiency. In terms of sectors, food processing and retail trade would benefit from international industrial expertise, especially when it comes to technological know-how. Furthermore, TAM will continue its regional scope beyond the main cities where management advisory services are not available.

Continuation of BAS

A Grant Guideline Matrix is proposed in Ukraine in order to prioritise intervention and avoid duplication of efforts from international donors. Depending on funding availability, higher grants will be allocated according to:

- *Size of enterprise*: Higher grants will be given to smaller enterprises.
- *Geographic location*: Higher grants will be given to enterprises outside of the capital city.
- *Type of advisory service*: Higher grants will be given to support more complex consultancy services aiming to improve management effectiveness, introduce quality management and certification and improve environmental management.

BAS assistance at the enterprise level will be complemented with the following market development activities in order to maximise the programme's transition impact in Ukraine:

- *Visibility and dissemination:* Steps will be undertaken to promote the use of business advisory services, especially in areas outside main towns as well as stimulate demand for more sophisticated consultancy services.
- *MSME and consultancy training*: Capacity building for local consultants will be organised to help broaden the country's supply and improve quality of local advisory services.
- *Support to and development of existing local institutions*: BAS will continue supporting local institutions that contribute to the development of MSMEs and the business advisory services market.

Cross-cutting objectives

TAM/BAS programmes will ensure a reasonable geographic distribution of projects in the country, while aiming to focus TAM projects on a few key sectors. TAM/BAS will continue supporting measures that support gender equality in business. Moreover, TAM/BAS will seek to incorporate measures that increase energy efficiency and environmental management into normal projects so as not to compete with other EBRD programmes on this sector.

Contribution to EBRD policy dialogue

Through their hands-on work with enterprises on the ground, TAM and BAS strengthen the EBRD's policy dialogue toolkit. The TAM/BAS programmes will support the Bank's engagement in policy dialogue with the Ukrainian agencies and will work in partnership with the Bank's initiatives geared to promoting the development of the MSME sector.

Annex 8 TECHNICAL ASSISTANCE

EBRD TC COMMITMENTS TO UKRAINE BY DONOR, 2008-2010

Donor	TC Commitments (€)
Austria	1,353,355
Canada	614,945
Czech Republic	581,988
EBRD Shareholder Special Fund	6,760,280
European Commission	15,877,657
Finland	119,500
France	1,521,700
Germany	146,000
Global Environment Facility	6,382,066
Italy	160,000
Netherlands	1,495,550
Spain	2,748,620
Sweden	1,935,372
Sweden	2,835,564
Taipei China	587,691
United Kingdom	33,100
World Bank	632,366
Total	**43,785,753**

EBRD TECHNICAL ASSISTANCE BY SECTOR

Sector	TC Commitments (€)
Agribusiness	208,517
Economic policy	90,000
Energy Efficiency and Climate Change	14,108,998
Environment	746,890
Financial Institutions	6,111,390
Municipal Environmental Infrastructure	12,251,335
Natural Resources	899,460
Power and Energy	3,847,267
Small Business Finance	2,450,000
TAM/BAS	1,443,096
Transport	350,000
Other	1,278,800
Total	**43,785,753**

Annex 9 SELECTED ECONOMIC INDICATORS

Ukraine

	2004	2005	2006	2007	2008	2009 *Estimate*	2010 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	12.1	2.7	7.3	7.9	2.1	-15.1	4.0
Private consumption	13.1	16.6	15.9	17.1	11.8	-14.2	na
Public consumption	1.8	2.7	2.7	2.8	0.4	-5.6	na
Gross fixed capital formation	20.5	3.9	21.2	24.8	1.6	-46.2	na
Exports of goods and services	21.3	-12.2	-5.6	3.2	5.2	-25.6	na
Imports of goods and services	15.5	6.4	6.8	19.9	17.1	-38.6	na
Industrial gross output	12.5	3.1	6.2	7.6	-5.2	-21.9	na
Agricultural gross output	19.1	0.4	2.5	-6.5	17.1	-1.8	na
Employment			*(Percentage change)*				
Labour force (end-year)	0.1	0.4	-0.2	0.3	0.3	-1.1	na
Employment (end-year)	0.7	1.9	0.2	0.8	0.3	-3.7	na
			(In per cent of labour force)				
Unemployment (end-year)[1]	8.6	7.2	6.8	6.4	6.4	8.8	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	9.0	13.5	9.1	12.8	25.2	15.9	11.0
Consumer prices (end-year)	12.3	10.3	11.6	16.6	22.3	12.3	13.0
Producer prices (annual average)	20.4	16.7	9.6	19.5	35.5	6.5	na
Producer prices (end-year)	24.1	9.5	14.1	23.3	23.0	14.3	na
Gross average monthly earnings in economy (annual average)	27.9	36.4	29.7	29.3	33.7	5.5	na
Government sector[2]			*(In per cent of GDP)*				
General government balance	-4.4	-2.3	-1.3	-2.0	-3.2	-11.3	-9.9
General government expenditure	41.5	44.1	45.1	43.8	47.3	48.5	na
General government debt	25.5	18.7	15.7	12.3	19.9	34.6	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	32.8	53.9	34.3	51.7	30.2	-5.5	na
Domestic credit (end-year)	24.8	34.3	69.4	77.0	76.9	3.9	na
			(In per cent of GDP)				
Broad money (M2, end-year)	36.4	43.8	47.7	54.3	54.0	53.0	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	9.0	9.5	8.5	8.0	12.0	10.3	na
Deposit rate[3]	7.8	8.5	7.6	8.2	9.9	13.8	na
Lending rate[3]	17.4	16.0	15.1	13.9	17.6	20.9	na
			(Hryvnias per US dollar)				
Exchange rate (end-year)	5.3	5.1	5.1	5.1	8.1	8.1	na
Exchange rate (annual average)	5.3	5.1	5.1	5.1	5.3	8.1	na
External sector							
			(In millions of US dollars)				
Current account	6,804.0	2,531.0	-1,617.0	-5,918.0	-12,763.0	-1,801.0	-1,200.0
Trade balance	3,741.0	-1,135.0	-5,194.0	-10,572.0	-16,091.0	-4,655.0	-6,000.0
Merchandise exports	33,432.0	35,024.0	38,949.0	49,840.0	67,717.0	40,394.0	46,000.0
Merchandise imports	29,691.0	36,159.0	44,143.0	60,412.0	83,808.0	45,049.0	52,000.0
Foreign direct investment, net	1,711.0	7,533.0	5,737.0	9,218.0	9,903.0	4,654.0	5,000.0
Gross reserves, excluding gold (end-year)	9,302.0	19,413.0	22,300.0	31,972.0	31,543.0	26,505.0	na
External debt stock	30,647.0	39,619.0	54,512.0	79,955.0	101,659.0	103,973.0	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.2	5.3	5.0	5.3	3.8	5.5	na
			(In per cent of exports of goods and services)				
Debt service[4]	4.6	4.9	5.1	4.0	2.7	5.8	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	47.1	46.7	46.5	46.1	45.8	45.5	na
GDP (in billions of hryvnias)	345.1	441.5	544.2	720.7	949.9	914.7	1,056.2
GDP per capita (in US dollars)	1,376.4	1,843.7	2,317.1	3,094.6	3,930.8	2,492.5	na
Share of industry in GDP (in per cent)	25.8	27.2	27.6	27.5	27.3	na	na
Share of agriculture in GDP (in per cent)	10.8	9.2	7.5	6.6	6.8	na	na
Current account/GDP (in per cent)	10.5	2.9	-1.5	-4.1	-7.1	-1.5	-0.9
External debt - reserves (in US$ million)	21,345.0	20,206.0	32,212.0	47,983.0	70,116.0	77,468.0	na
External debt/GDP (in per cent)	47.3	46.0	50.6	56.0	56.4	91.7	na
External debt/exports of goods and services (in per cent)	77.2	89.3	108.5	124.9	118.7	191.6	na

[1] According to ILO methodology.

[2] IMF definition. General government includes the state, municipalities and extra-budgetary funds, in 2009-10 Naftogaz, bank recapitalisation costs, and issuance of VAT bonds.

[3] Weighted average over all maturities.

[4] Refers to payments on official debt only.