Annex 1 - Annual Action Programme 2012 for Ukraine, part 2

1. IDENTIFICATION

Title/Number	Continued support for the implementation of Ukraine's energy strategy ENPI/2012/023-677		
Total cost	EU contribution: EUR 45 million		
Aid method / Method of implementation	Sector Policy Support Programme: - Sector budget support (centralised management)		
DAC-code	23010	Sector	Energy policy and administrative management

2. RATIONALE AND COUNTRY CONTEXT

2.1. Country context and rationale for SPSP

2.1.1. Economic and social situation and poverty analysis

From 2000 to 2007, Ukraine's economic performance was strong and poverty decreased substantially, but the economic crisis hit Ukraine hard in late 2008. After experiencing one of the sharpest downturns in the region in 2009, according to the State Statistics Service, real GDP growth was 4.2% in 2010 and 5.2% in 2011, helped by export-oriented industries, particularly steel, but increasingly also by domestic demand.

For 2012, the International Monetary Fund (IMF) has reduced its forecast of GDP growth in Ukraine in 2012 down by 1.8 percentage points to 3% and is expected to revise it further downwards in autumn 2012. GDP growth in 2013 is expected to be 3.5%.

Inflation remains below 10% and some national and international experts predict increasing pressure on the currency which might result in a devaluation of the Hryvnia (UAH), the National Bank of Ukraine late in December 2011 forecast 7% inflation in 2012, provided monetary policy stays unchanged and there are no significant external shocks.

Ukraine scored 76th out of 187 in the 2011 Human Development Index (HDI), in the group of High Human Development. The HDI of Europe and Central Asia as a region increased from 0.644 in 1980 to 0.751 today. In 1990, Ukraine's index was at 0.707, reaching 0.729 in 2010.

2.1.2. National development policy

As a sign of the advanced state of the EU-Ukraine energy cooperation under the Eastern Partnership and the European Neighbourhood Policy (ENP) cooperation, a Memorandum of Understanding (MoU) on energy cooperation was signed at the 2005 Summit. This document now forms the principal basis for energy cooperation and sets out how the two sides plan to organise work to bring energy markets closer together. The MoU establishes a joint strategy towards the progressive integration of the Ukrainian energy market with that of the EU and consists of road maps covering four specific areas: (1) nuclear safety, (2) integration of electricity and gas markets, (3) enhancing the security of energy supplies and the transit of hydrocarbons, (4) improving the effectiveness, safety and environmental standards in the coal sector. A 5th roadmap on energy efficiency (EE), renewables and measures to tackle climate change was signed in March 2008.

One of the key priorities in EU-Ukraine energy cooperation foreseen by the MoU was Ukraine's joining the Energy Community Treaty (EnCT). Having had an observer status since November 2006, Ukraine became a full-fledged member of the Energy Community as of 1 February 2011. The legal framework and obligations provided by the EnCT, also reflected in the Association Agenda that prepares for the Association Agreement/DCFTA (see further below) will be of important help to Ukraine on its way of reforms as it covers a precise agenda of legislative and regulatory reforms, a.o. in the area of market organisation, competition, regulatory principles and transparency. These reforms are not easy and require a strong political endorsement and a wide-spread understanding among the business community and the population. A first set of deadlines for the Energy Community commitments passed on 1 January 2012, covering, inter alia, *electricity and gas market opening for non-household customers, unbundling and third party access,* which was only partly met by Ukraine. It is therefore of high importance that further progress is made by Ukraine in order to comply with the commitments it has entered into and that Ukraine is in a position to meet new obligations being adopted under the EnCT. Currently, Ukraine is implementing the 2nd EU Energy Legislative Package, but the 9th EnCT Ministerial Council meeting held on 6 October 2011 invited Ukraine to expedite the internal procedure of approval the decision on the implementation of Directive 2009/72/EC, Directive 2009/73/EC, Regulation (EC) No 714/2009 and Regulation (EC) No 715/2009 and amending Articles 11 and 59 of the Energy Community Treaty – third internal energy market package. Ukraine is still in the process of developing its position with this regard. The Ministerial Council meeting on 18 October 2012 is set to decide on the extension of the EnCT *acquis* to cover oil stocks, statistics and renewable energy sources (RES). In this context, on 21 June 2012, a meeting of the EnCT Permanent High Level Group (PHLG) was held which noted Ukraine's support on including the oil stocks and statistics legislation in the list of the EnCT *acquis*. With regard to the Directive 2009/28/EC on the promotion of the use of energy from RES, Ukraine is preparing its position for the EnCT Ministerial Council meeting.

The cooperation in the energy sector continues to be high on the agenda of the EU-Ukraine relations. The Communication on security of energy supply and international cooperation adopted by the Commission in September 2011 confirmed that the EU-Ukraine energy cooperation should be intensified in the coming years. This document, in particular, called for: (i) support to the rehabilitation of the Ukrainian gas transmission network by 2020; (ii) extension of the validity of the EnCT beyond 2016, and (iii) implementation of ambitious EE & RES energy policies.

The envisioned deepening of relations between EU and Ukraine in the context of the Eastern Partnership, through an Association Agreement (including a Deep and Comprehensive Free Trade Area as an integral part, AA/DCFTA), involves unprecedented regulatory approximation. To prepare for and facilitate the entry into force of the AA/DCFTA, the EU and Ukraine have jointly agreed on an implementation tool, the Association Agenda, which covers key reforms in all areas of the future agreement, including in the field of energy. In this framework, the parties agree on a set of priority reforms on an annual basis.

The national development framework is broadly defined by the *Economic Reform Programme for 2010-2014*[1] *(ERP)*, adopted on 2 June 2010 at the meeting of the President's Committee for Economic Reform. The sector reforms foresee three stages: Stage I - by end 2010, Stage II

[1] Unofficial translation in English is available at http://www.usubc.org/site/files/Ukraine_Program_of_Economic_Reforms_2010-2014.pdf

- by end 2012, and Stage III - by end 2014. The ERP covers important policy goals related to sustainable economic development, improving social services, improving the business climate, attracting more investment and modernising the infrastructure. The ERP is linked to the main priorities of the EU-Ukraine Association Agenda, including the measures related to the establishment of a Deep and Comprehensive Free Trade Area, visa liberalisation, cooperation in energy and other sectors.

By decision No. 1724 of 23 June 2010, the government of Ukraine committed itself to implement the ERP. Ownership of the ERP by the government is ensured through giving personal responsibility to ministers for relevant reforms areas in line with the presidential decree No. 1154 of 21 December 2010. However, the ERP leaves a substantial room for the timing of the implementation process, and is unspecific regarding indicators or specific achievements. The implementation of the ERP is institutionalised – it is coordinated by the Coordination Center for the Implementation of Economic Reforms under the presidential administration and is chaired by the president himself. The president issues annual action plans to implement the programme's priorities. The *National Action Plan for 2012* was approved on 12 March 2012.

2.2. Sector context: policies and challenges

(1) Sector Context

Ukraine's Energy Strategy until 2030, approved in 2006, outlined the overall energy policy and establishes strategic goals for the development of all energy sub-sectors. It represented a significant milestone by providing a development strategy for the sector. Nevertheless, many of the projections in the strategy are contentious, as they were not developed on the basis of detailed statistical data and models. There was an emphasis on supply measures at the expense of energy demand and efficiency. In this context, the ERP called for the review of the Energy Strategy. The original plan of the government was to finalise the revision process by the end of 2011, but the deadline has been shifted many times. It is important that the new strategy is comprehensive and sustainable, is founded on sound data, reinforces Ukraine's energy security and takes into account the commitments taken by Ukraine when joining the EnCT as of 1 February 2011. On the latter, the strategy should pay serious attention to the deadlines of Ukraine's existing legal framework harmonisation with the norms of Energy Community *acquis*. The commitments are reflected in the Association Agenda, which prepares for the Association Agreement/DCFTA.

The draft revised Energy Strategy of Ukraine was released for public consultations in the middle of June 2012. On 17 July 2012 a joint EU-WB-US letter was sent to the Minister of Energy. The letter in particular supported the reform-oriented market-based approach underlying the draft Energy Strategy with the objectives to ensure the cost-recovery electricity tariffs, eliminate cross-subsidies and develop a wholesale electricity market. Beyond that, the letter emphasized, inter alia, the following points:

A clear view on the prioritization of reforms and investments is needed.

EnCT commitments are acknowledged, but no analysis on challenges as well as implementation timeline for EnCT commitments is provided.

The information provided suggests that the prime driver is to reduce dependence on gas imports from Russia whereas energy demand policy measures remain secondary. (There is, however, a target of reduction of 30-35% in energy intensity by 2030.)

Consistency with the approved Environmental Strategy should be ensured (e.g; with regard the intentions regarding to the coal sector).

It will be also important to ensure that the government takes due account of the conclusions of the in-depth review of Ukraine's energy sector done by the International Energy Agency (IEA) in 2012.(Report due in autumn 2012, draft findings and recommendations were presented by the IEA to the government at the end of February 2012 (attached in annex I).

In 2009, the government of Ukraine decided to join the Extractive Industries Transparency Initiative (EITI). In April 2012 during the Open Government Partnership summit Ukraine announced to implement this initiative. Ukraine has made some albeit limited progress to implement the EITI. Government has fulfilled 3 of the 5 sign-up indicators (statement of intention to implement EITI, appointment of national coordinator, commitment to work with civil society and companies) and has started to work on the 4th sign-up criteria, which is the creation of the multi-stakeholder group (MSG). The creation of the MSG and drafting of an implementation action plan (5th sign-up criteria) are still outstanding. However, the government has indicated that it plans to resolve them by autumn 2012.

The energy sector and its sub-sectors attract considerable attention in the ERP. For energy, as for the other sectors, the programme discusses in a very structured manner (1) challenges; (2) aims and objectives and (3) perceived necessary steps to be taken (energy part of the National Action Plan for 2012 in English is attached in annex II). In line with the provisions of the ERP, the government launched a privatisation programme in the electricity and gas sectors in the middle of 2011.

Aiming at supporting Ukraine on the path of comprehensive reforms in the energy sector, the EU launched AAP 2007 Energy SPSP for the total amount of EUR 87 million in 2008, in particular using the budget support instrument – for the first time in the ENPI East region. This programme was completed in 2011.While this first SPSP had faced several difficulties in course of its implementation, both in terms of delays in foreseen disbursements and in achievement of the results, the Delegation's assessment of the level of attainment of performance indicators done based on the government's progress report exceeded 70%. Being guided by the importance of comprehensive reforms in the energy sector, the Ukrainian government has confirmed its interest in extending the ENPI AAP 2007 SPSP into a next stage to allow for a further deepening and increased sustainability of the reforms initiated in course of the first SPSP. It was recognized, however, that formulation of the new SPSP should gain from lessons learned during the first programme. These include: (a) clearer formulation of performance indicators and (b) swiftly making the Joint Monitoring Group (JMG) operational and consistent monitoring and reporting.

Since the middle of 2010, the majority of problems experienced by the AAP 2007 Energy SPSP had been resolved, i.e. (a) the programme had shown evident progress in the fulfilment of the indicators, and (b) the JMG started to have regular technical meetings and the reporting system considerably improved.

As a result, it can be expected that the new programme will build on this improved environment.

Ukraine being a member of the EnCT now must ensure that all developments in the energy sector respect its EnCT obligations. One of the biggest obstacles right from the start has been compliance with the EU's (and EnCT's) rules on emissions of large combustion plants. A more recent development in the EnCT is the intended extension to EU oil *acquis* and in particular oil stocks rules. A further area of high energy policy and environmental importance is the harmonisation with the EU fuel products quality standards and effective implementation of these standards.

(2) Sector budget

There is neither an overall medium term fiscal framework (MTFF) nor a medium term expenditure framework (MTEF) for the sector. The draft revised Energy Strategy provides government's estimate for financial and other resources needed to implement the reforms in the energy sector.

The state budget allocates funds to the Ministry of Energy and Coal Industry, National Energy Regulatory Commission (NERC) and the State Agency for Energy Efficiency and Energy Conservation (SAEE).

In the budget for fiscal year 2011, the total for the three executive authorities was approximately UAH 10,650 million (ca. EUR 970 million). Of this, the allocation for the Ministry was UAH 10,021 million (or 94 %), including state aid to the coal producing companies for the amount of UAH 6,710 million; for SAEE UAH 625 million (5.6 %), including allocation for implementation of the state programme on energy efficiency with UAH 600 million; and for NERC 30.5 million (0.2 %). In addition, outside this framework the budget provides huge allocations for subsidies to offset the commercial impact of government fixed concessionary electricity, gas and heat tariffs, accounting for UAH 7,000 million (ca. EUR 650 million).

In the budget for fiscal year 2012, the total for the three executive authorities is UAH 11,071 million (ca. EUR 1,100 million). Of this, the allocation for the Ministry is UAH 10,502 million (or 94.86%), including state aid to the coal producing companies for the amount of UAH 7,802 million; for SAEE UAH 534 million (4.8%), including allocation for implementation of the state programme on energy efficiency UAH 502 million; and for NERC UAH 35 million (0.3 %). The budget for 2012 still provides very significant - although compared to 2011 considerably reduced - allocation for subsidies to offset the commercial impact of government fixed concessionary electricity, gas and heat tariffs, accounting for UAH 4,575 million (over EUR 400 million).

(3) Coordination with beneficiary country and other donors

The international affairs department in the Ministry of Energy and Coal Industry of Ukraine is in charge of coordination of the sector policy dialogue with the EU, including coordination of the EnCT process in Ukraine. The management and staff of the department show their commitment to the cooperation in the sector, including in the framework of the present new sector policy support programme (SPSP). However, coordination of this department with other departments in the ministry being in charge of implementation of specific energy related tasks of the ERP is not smooth and requires considerable improvement. This problem also affected the implementation of the ENPI AAP2007 Energy SPSP (ENPI/2007/18788) for which the joint monitoring mechanism was insufficiently coordinated with the policy dialogue that led to the absence of the joint monitoring group meetings at the high level.

Donor coordination is formally ensured by the government, via thematic working groups, but meetings have not been arranged regularly. Thus, in view of a rather weak government-led coordination process, a coordination process is on-going between the donors. It is recognised, however, that in order to be effective the donor coordination process in Ukraine requires leadership from the beneficiary side (see also section 2.6).

(4) Institutional Capacity

The Ministry of Energy and Coal Industry of Ukraine is the main body of central executive authority in charge of development and implementation of state policy in the electricity sector, nuclear and coal industry, peat mining, oil and gas sector and governs the state-owned shares of NJSC "Naftogaz of Ukraine" (100 %) and NJSC Energy Company of Ukraine (100 %). The ministry is also in charge of the implementation of the Energy Strategy until 2030 and relevant reporting as well as is responsible for coordination of the EnCT process.

In course of the implementation of the ENPI AAP 2007 SPSP "Support to the implementation of Ukraine's Energy Strategy" the Joint Monitoring Group (JMG) was set up and co-chaired by the ministry. To prepare the new budget support programme an interdepartmental working group was established by the order of the ministry in order to develop the list of indicators for the present 2nd phase of the SPSP "Support to the implementation of Ukraine's Energy Strategy". Since 2010, the ministry has been receiving the capacity building technical assistance in the framework of the ENPI AAP 2007 SPSP. The project will continue until the end of September 2012. Nevertheless, the coordination and communication between the Ministry of Energy and Coal Industry of Ukraine and other stake-holding ministries and state institutions is rather weak and too formalised. This problem negatively influences the progress towards the fulfilment by Ukraine its international commitments as well as the current policy dialogue in the energy sector. Further technical assistance could be programmed, if adequate justification is provided, and a satisfactory level of ownership is demonstrated by the Government.

(5) Performance Monitoring

The energy sector policy implementation in Ukraine is currently being monitored by the Coordination Center for the Implementation of Economic Reforms under the presidential administration in the framework of implementation of the ERP and the cabinet of ministers of Ukraine in the framework of implementation of the Energy Strategy of Ukraine until 2030. Considering, however, that the relevant reporting is not public, at this stage, it is difficult to assess whether these monitoring processes are aligned and whether necessary follow up is ensured.

The EU-Ukraine bilateral documents also foresee the monitoring mechanisms, in particular the implementation of the Association Agenda foresees regular reporting system by the Ministries and the state institutions to the Ministry of Economy of Ukraine; regular EU-Ukraine Cooperation Committee and the relevant Sub-committee meetings are held; furthermore, since 2005 annual joint progress reports have been prepared and signed by both parties in the framework of the EU-Ukraine Memorandum of Understanding in the field of Energy.

In addition, since February 2011 there is a monitoring mechanism in place for Ukraine's EnCT obligations with annual implementation reports drafted by the Secretariat and approved by the Energy Community Ministerial Council meetings. The first implementation report covering Ukraine's progress in the EnCT will be finalised by 18 September and approved by the EnCT Ministerial Council meeting on 18 October 2012.

It should be noted, however, that an evaluation done for the ENPI AAP 2007 Energy SPSP concluded that current policy planning and implementation process in Ukraine (not only in the energy sector) does not foresee setting of targets for policy changes as well as measurable indicators to assess the outcomes of these changes (copy of the evaluation report is attached in annex III). It is therefore important that the on-going process for the Energy Strategy revision takes due note of this problem and addresses it in dialogue with the Ukrainian government.

(6) Macroeconomic framework

Ukraine was among the EU neighbourhood countries hardest hit by the global economic crisis. From late 2008, it suffered a parallel balance of payments and banking crisis, and output contracted by nearly 15% in 2009. From 2010 onwards, Ukraine's real GDP grew, by 4.2% in 2010 and 5.2% in 2011, thanks to strong domestic demand and a recovery in exports. However, prospects for 2012 are less favourable, mainly due to lower external demand. The latest GDP real growth data published (+1.5% y/y in the first 8 months of 2012) underlines the downside risks to the assessment by the World Bank (WB), the European Bank for Reconstruction and Development (EBRD) and the International Monetary Fund (IMF), which expect between 2 and 3% GDP growth in 2012 (NB: the Government has so far not revised its official 2012 GDP growth forecast of 3.9%).

Fiscal performance has been mixed. On the one hand, the general government deficit shrank from 6.3% of GDP in 2009 to 2.7% of GDP in 2011. On the other hand, the deficit of Naftogaz continues to affect the overall deficit as the government has so far failed to bring prices for households and utilities in line with cost-recovery levels in spite of a number of price increases. The 2012 overall deficit is expected to reach 5.3% of GDP (3.3% general government plus 2% Naftogaz) as a consequence of higher gas prices and higher social spending before the October 2012 elections. Meanwhile, the government maintains its 2.5% of GDP overall deficit target, referring to increased revenue forecasts which the IMF assesses as optimistic.

The deficit of Naftogaz Ukrainy (NG) will most likely miss the target (0.7% GDP) and is forecast to reach 2% GDP this year. The company's finances continue to suffer from failure to raise domestic tariffs, as well as higher import costs and lower than expected payment compliance. Rather than increasing gas prices received by NG from households and heating utilities by 30 and 58%, respectively, in 2011, as agreed with IMF, the authorities reduced them by 20% and 6%.[2] Domestic tariffs received by NG remain a small fraction of the actual cost of imported gas.

Ukraine's external position worsened as the current account deficit rose from 2.2 in 2010 to 5.5 per cent of GDP in 2011. Ukraine's current account (C/A) deficit reached 3.6 billion USD in 1H2012 (2% GDP), going above the respective gap in 1H2011 (2.75 billion USD). The C/A balance is set to deteriorate further in the year, largely on weakening foreign demand. IMF projects that the C/A balance will reach 6.4% GDP in end 2012 and deteriorate further to 7.6% GDP in 2013. The IMF highlights that there are downside risks even to this forecast, as any worsening of euro area turbulence or global growth could have significant additional negative implications for Ukraine.

Consumer prices grew by 4.6% year-over-year in 2011, down from 9.1% in 2010 and the lowest year-over-year record since May 2003. Food prices, accounting for 54% of Ukraine's consumption basket, drove inflation down last year, as a strong domestic harvest (grain, sugar, fruits and vegetables) along with declining global food prices kept domestic price growth low The consumer price index continued to hit historical lows, having reached 1.2% y/y in

[2] Here, the reference goes not to the nominal tariffs per se but the price of gas as a commodity that is the part of the tariff which ends up with NG and has an impact on its cash receipts. The composition of the tariff is the following – (a) price of gas as a commodity, (b) transportation tariff for TransGas, (c) transportation tariff for oblgases, and (d) surcharge (mark-up) on the gas price. For the period observed the nominal level of the tariff remained unaltered while the market regulator kept increasing (b) and (c) which eventually shrank the portion of NG's share of the pie.

1H2012 (2.9% y/y in 1Q2012), as m/m deflation was recorded in May and June. At the same time, core inflation (calculated on the basis of the consumer basket from which seasonal foods and fuels are excluded) was 5.1% y/y over the period, suggesting that inflation will pick up again as a result of this year's anticipated decline in the crop harvest (due to the less favorable weather conditions compared to the last year). The potential impact of possible rises in food prices, particularly in an election period, is being watched very closely by the government, which has recently given reassuring messages about the harvest and stock of grain, including confirmation that there are no plans currently to introduce export restrictions. IMF currently forecasts headline CPI to accelerate to 7.4% y/y by end-2012 given rising food prices and pressures from rising wages (propelled by social initiatives of the government).

In November 2008, the IMF board approved a USD 16.5 billion or Special Drawing Rights (SDR) 11 billion Stand-By Arrangement (SBA). However this SBA was interrupted in November 2009 due to slow progress in a number of agreed structural reform priorities. By that time, Ukraine had drawn some USD 10.6 billion under the programme. A new 29-month USD 15.2 billion SBA was approved in July 2010. Following the successful conclusion of the first review under the current SBA, Ukraine received the first tranche of USD 1.89billion. The second review – originally scheduled for conclusion at end-March 2011– is yet to be completed. The main reasons are disagreements over gas prices. The latest Article IV review, finalised in June 2012, concluded that vulnerabilities were elevated given significant external and fiscal funding needs while risks of external shocks could worsen Ukraine's growth outlook. The IMF recommended to immediately address the issues of fiscal adjustment as well as the monetary and exchange rate policy framework, and to strengthen the banks' balance sheets, while implementing structural adjustment, notably in the energy sector. The contact between the two partners is permanent and in August, First Deputy Prime Minister Khoroshkovskiy met with IMF's Managing Director Lagarde in Washington, asking for a new mission to be sent. An IMF mission took place from the 28th of August to the 5th of September to discuss the country's 2013 budget, energy sector reform and social programs. Giving growing fiscal and external financing pressures, the government may request a new standby-arrangement after the elections, as the chances of re-activating the current SBA, which lapses in December 2012, are very low. A new active SBA with the IMF would considerably reduce existing macroeconomic risks and negotiations will therefore be monitored very closely.. A €610 million macro-financial assistance package for Ukraine is under preparation by DG ECFIN (Inter-service consultation closed on the 6/9/12) while its implementation will depend on a positive assessment of the political pre-conditions after the parliamentary elections and the IMF programme being on-track.. Ukraine's competitiveness benefits from a healthier macroeconomic environment than in previous years moving up 9 points in the Global Competitiveness Index 2012-2013 (from position 82 to 73). As a conclusion the risks of internal (related to the increasing fiscal deficit) and external (related to the Euro-crisis, the exchange rate and the increasing current account deficit) vulnerabilities are monitored closely. In summary, macroeconomic risks remain significant, notably related to GDP growth, the fiscal deficit, and the balance of payments.

(7) Public Financial Management (PFM)

The Public Expenditure and Financial Accountability (PEFA) Assessment 2011 for Ukraine (update of the 2006 PEFA Assessment) was published in July 2012. Ukraine scores 2.67 out of 4 above the worldwide average of 2.53. This indicates that the country has established fundamental PFM systems but there is still considerable scope for improvement. Ukraine performs well on execution control, transparency and predictability of the budget, as well as, on accounting and reporting. But, given its aspirations and potential, Ukraine is lagging behind on credibility of the budget and policy based budgeting. It scores as an average performer on the rest of the dimensions. For example, external scrutiny and audit is among the weakest one, undermined by the limited mandate of supreme audit body, the Accounting Chamber of Ukraine, and limited parliamentary scrutiny. Public procurement, very important to the EU, has been a difficult area with progress and setbacks and recent bills on state procurement (adopted in July) further reduces competition and, according to experts, oversight of state purchases.

Progress in PFM has been fragmented and not based on a comprehensive PFM reform programme. Therefore, Commissioner Füle wrote to the Deputy Prime Minister in January 2012 requesting for a comprehensive PFM Reform Strategy and a mutually agreed Action Plan in order to resume BS payments which are under review since end of 2011. The GoU has taken some positive steps to improve the situation and consolidate efforts of all players of PFM Reform. The Intergovernmental PFM Working Group was established, covering different aspects of PFM. A Concept Note to develop PFM has been formally approved by the Cabinet of Ministers on the 4th of September under the authority of the Minister of Finance, and the endorsement of the Ministry of Justice. The Concept has taken major EU recommendations into account and should facilitate the subsequent elaboration of the Strategy and Action Plan with clear timelines and responsibilities.

2.3. Eligibility for budget support

(1) Confirmation that a well defined sector policy is in place or under implementation:

The 2006 Energy Strategy is in place and under implementation.

In parallel, the government is currently finalising key reforms for the energy sector based on the provisions of the Economic Reform Programme for 2010-2014 namely:

- revision of the 2006 Energy Strategy is on-going. Prior to adoption, it is important to ensure transparency of consultations with civil society and donors. The revised strategy together with the work plan should be based on sound data, have targets for policy changes and measurable indicators to assess the policy outcomes as well as take into account Ukraine's international obligations;
- the government supported the International Energy Agency's in-depth review for Ukraine which started in 2011 with the report to be ready in autumn 2012 and announced to take into account its conclusions in the revised Energy Strategy;
- Ukraine is a member of the Energy Community as of 1 February 2011 and is in the process of implementation of its obligations. It is important that Ukraine approves an action plan on implementation of the commitments as well as follows the deadlines established in the Protocol on Ukraine’s Accession (*"Key issues in the context of implementation of the EnCT acquis, raised by the Energy Community Secretariat during the meeting on the occasion of the Day of Ukraine in the Energy Community held in Vienna on 18 April 2012"* are attached as annex IV);

Although the process of modifying the existing energy sector policy framework is not finalised yet, it is well under way. As the credibility and relevance of the revised Energy Strategy will depend on it, increased clarity on the content of the revised Energy Strategy and on the way it takes up the IEA's recommendations and ensures steps towards fulfilment of EnCT commitments should, however, be a precondition for this programme. Progress in finalising the strategy is satisfactory and does not put the eligibility for a new sector budget support programme into question at this stage.

(2) Confirmation that the macroeconomic stability eligibility criterion is met (for detailed assessment, see section 2.2.)

Hit hard by the economic crisis in 2008 and 2009, Ukraine has shown positive growth rates in subsequent years. However, other economic indicators have been a cause of concern, in particular the C/A deficit has a high probability for keeping increasing (to around 6.4% GDP in end 2012, and there are significant downside risks even to this forecast), whereby the financial drain of the Naftogaz' deficit on the budget deserves special mentioning. It is at present difficult to conclude on the perspectives for macro-economic stability and future negotiations with the IMF and the impact of the Euro-crisis will be closely followed up. The macroeconomic situation, however, does not put into question the eligibility for a new sector budget support commitment.

(3) Confirmation that the PFM eligibility criterion is met (for detailed assessment see section 2.2) including confirmation that a credible and relevant programme to improve PFM is in place or under implementation

As outlined above, progress on PFM has been mixed, as positive developments in some areas (remit of the Accounting Chamber) have been countered by lack of progress or even backtracking in other areas (public procurement). The Concept Paper adopted in September 2012 is an important step towards the formulation of the requested comprehensive PFM reform strategy and action plan, which has been commissioned by the Cabinet of Ministers early September. It is expected that the latter will be finalised before the signature of the Financing Agreement. Progress in PFM is underway and does not put into question the eligibility for a new sector budget support commitment.

(4) Transparency and oversight of the budget

The 6 indicators measuring Comprehensiveness and Transparency in the PEFA exercise have basically remained the same from 2006 to 2011 (2xA; 1xB+; 1xB and 2xD+). Budget comprehensiveness is generally good and the budget classification system covers administrative, economic and program classifications. The existence of four important social insurance funds and other hypothecated funds, reported separately from the main budget, negatively affects budget transparency. The new Budget Code envisages that all extra budgetary funds report using International Public Sector Accounting Standards (IPSAS) compliant national accounting standards starting 2013, which will be the first step towards consolidated reporting. Public access to key fiscal information scores a B in the 2011 PEFA report (as in 2006). The report concludes that Ukraine makes significant amounts of fiscal information available to the public and scored highly (19^{th} out of 94 countries rated) in the 2010 Open Budget Index (good OBI score compared to other countries in the region). The recently approved PFM concept note includes further elements to improve transparency. Progress is thus satisfactory.

2.4. Lessons learnt

In 2011, an evaluation of the ENPI AAP 2007 energy sector SPSP was carried out with the final report leaving open the possibility for a follow up energy sector support programme provided that the government decides on its policy priorities. Based on the evaluation report as well as experience of other SPSPs currently on-going, the following lessons have been learnt:

- the sector policy and the corresponding expenditure framework should be in place;
- SPSPs should be designed around a sector policy, the implementation of which is comparable in terms of duration;

- SPSPs should be a part of policy dialogue in the sector;
- a permanent and well-defined system should be developed to monitor the SPSP implementation, but this system should be aligned with the government's monitoring system of sector policy implementation;
- the SPSP indicators must be unambiguous, relevant, achievable and have a realistic timeframe. A better formulation of SPSPs with identified S.M.A.R.T. (specific, measurable, attainable, relevant and timely) indicators for each measure should promote better policy planning and service delivery;
- priority should be given to indicators which have the most significant potential for economic and social impact;
- given its role as coordinator of the EU assistance on behalf of the government, the Ministry of Economic Development and Trade of Ukraine should be strengthened in order to play a bigger role in the development of SPSPs e.g. by co-chairing the JMGs;
- a dedicated mechanism needs to be put in place to ensure that resources are used for the purposes for which they were intended and the use of special funds versus untargeted budget support in the implementation of SPSPs should be analysed and avoided.

2.5. Complementary actions

The Ukrainian energy sector and energy sector reforms have been in the focus of international donor activities since Ukraine's independence in 1991. A very large number of technical assistance and support projects have been implemented by donors, including the EU, EBRD, WB, UNDP and USAID. Currently, there are the following on-going EU-funded projects that can complement the new budget support programme objective:

- AAP Ukraine 2007 TA "Complementary TA to the EU funded BS to Ukraine's Energy Strategy" - end in September 2012;
- AAP Ukraine 2011 Twinning Project to the NERC in the development of gas sector regulation in the framework EnCT *acquis* – end in September 2012;
- AAP Ukraine 2008 TA "Capacity building of the State Agency for Energy Efficiency (SAEE)" - end in 2014;
- AAP Ukraine 2008 Twinning Project to the SAEE “Improvement of the policy framework in the sphere of energy efficiency and its approximation to the requirements of the EU legislation" - end in July 2013;
- AAP Ukraine 2007 TA "Support to Ministry of Ecology and Natural Resources for the SBS implementation" – end in March 2013;
- AAP Ukraine 2008 CA "IEA in depth review for Ukraine" – end in October 2012.

2.6. Donor coordination

Donor coordination is formally ensured by the government, via thematic working groups, but meetings have not been regular. In view of a weak government-led coordination process, coordination process is on-going between the donors. It is recognised, however, that in order to be effective the donor coordination process in Ukraine requires leadership from the beneficiary side.

Coordination between the donors covers two main areas: assistance to Ukraine in the framework of implementation of the EnCT commitments and the provisions of the 23 March 2009 Gas Transit Declaration. As regards the first one, since the end of 2011 the Delegation and the Ministry of Energy and Coal Industry of Ukraine are discussing the need to convene the donor coordination meeting under the leadership of the Ministry on the EnCT-related assistance with no success so far. In this context, it should be noted that EnCT-related coordination between the donors is negatively influenced by the delay with the preparation of the Action Plan for implementation of the EU energy legislation. As regards gas transit, modernisation of the gas transit system, restructuring of NJSC "Naftogaz of Ukraine", the EU-EIB-EBRD-WB-Ukraine dialogue continues. The progress has recently increased with respect to the implementation of the gas sector reforms.

3. DESCRIPTION

3.1. Objectives

The overall objective for this new SPSP in the energy sector is to provide for the energy needs of the Ukrainian economy and society in a safe, efficient and economical way, and to support alignment with EU norms for energy and the environment and Ukraine's EnCT commitments also reflected in the Association Agenda that prepares for the Association Agreement/DCFTA. The SPSP is designed to support the continuing implementation of the sector strategy, including the deepening of reforms in the key areas, facilitate the respect of Ukraine's commitments under the EnCT, strengthen the financial sustainability in the energy sector and ensure greater transparency and environmental awareness in the energy sector.

The specific objectives of the new SPSP address areas which are complementary to areas and goals pursued in the first SPSP, the SBS on energy efficiency as well as to cooperation with Ukraine and international financial institutions (IFIs) on the issues of reform of the Ukrainian gas sector and rehabilitation of the Ukrainian Gas Transit system. These specific objectives, stemming either from the EnCT or the Association Agreement, are as follows:

- Improvement of oil products quality and introduction of a system for quality checks with a view of adoption of EURO-4 and EURO-5 standards;
- Improvement of energy security through set up of the system of oil and oil products stocks;
- Reduction of the environmental pollution related to the energy sector and in particular progress towards the implementation of the Large Combustion Plant directive (2011/80).

It can be noted that an enhanced energy policy dialogue, which is both a precondition and an implementing tool for this SPSP, constitutes an important element in the overall political dialogue between the EU and Ukraine. The policy dialogue in the programme in reference is seen as a continuation of the policy dialogue established in the 2007 and 2008 SBS in the energy and energy efficiency/renewable energy sectors. The respective forums such as the technical and high-level joint monitoring group meetings, beside monitoring indicators of the current programme, will serve to continue monitoring relevant indicators from the two previous programmes and thus strengthen and consolidate the overall energy sector policy dialogue.

3.2. Expected results and main activities

- Enforcement of the National Standards DSTU 4839:2007 and DSTU 4840:2007 concerning the quality of oil products and strengthening the quality control system for compliance with national standards for oil products, which would be auditable and legally enforceable;
- A statement of approach (model) to be adopted by Ukraine for holding the oil security

stocks that will be implemented, the establishment of the necessary mechanisms and a plan to progressively build up the crude oil and oil product stocks, in particular in line with the forthcoming obligations under the EnCT, as well as transposition of the oil stocks *acquis*, which would permit Ukraine to begin building its stocks by 2015 at the latest;

- Adoption of a state target programme on the reduction of emissions of certain pollutants into the air from the large combustion plants in the electricity sector of Ukraine to prepare for Ukraine's compliance with the EnCT *acquis*. This should include a detailed analysis of the needs and a strategy for achieving the necessary investments.

In order to achieve the results provided, the following main activities will be supported:

- Development of mechanisms and capability for oil products quality control which would be auditable and legally enforceable, as well as timetable for gradual transition to the EU quality standards. This may include the necessary legal basis (including as regards sanctions), capacity building (inspectorate) and equipment;
- Development of a plan to progressively build up the crude oil and oil product stocks in line with the obligations under the EnCT (to be agreed by the Ministerial Council in October 2012);
- Development and adoption of the state target programme on the reduction of emissions of certain pollutants into the air from large combustion plants in the electricity sector of Ukraine in line with the obligations under the EnCT. This should include a detailed analysis of the needs and a strategy for achieving the necessary investments.

3.3. Risks and assumptions

The key risks that could possibly affect the success of the programme are the following:

Assumptions

- Ukraine continues to be politically engaged in developing and deepening its relationship with the EU and to maintain its commitment to EnCT obligations;
- Ukrainian government is open for full cooperation within the programme with proper policy and technical dialogue between all stakeholders and the EU ensured;
- The Commission continues to monitor closely any significant movement in the Ukrainian energy sector.

Risks

- The revision process for the Energy Strategy leads to results which are insufficiently in line with the commitments Ukraine entered into when joining the Energy Community.

  Mitigation: continued assistance to the government and other stakeholders in course of the review and discussions on the strategy. If necessary, technical assistance related to the advice in the process of Energy Strategy revision can be provided by EU and/or other donors. Disbursement modalities (no fixed tranche).

- Political or economic considerations result in a change of commitment to the energy-related chapters of the AA/DCFTA and the Protocol on Ukraine's Accession to the EnCT or lack of support of relevant new Energy Community obligations (Oil Stocks

Directive), or lack of political commitment to move ahead on fuel quality improvements and monitoring.

Mitigation: high-level political and policy dialogue; disbursement modalities (no fixed tranche).

- Ukrainian authorities are not addressing corruption and conflict of interest, in particular in the energy sector.

  Mitigation: high-level political and policy dialogue.

- PFM remains weak without clear reform strategy.

  Mitigation: policy dialogue with involvement of all relevant stakeholders, on-going technical assistance.

- Possible deepening of the global economic crisis adversely affects the government's ability and willingness to pursue reforms in the sector, and deterioration of income levels undermines the government's willingness to introduce commercially based tariff regimes if primary energy prices stay at a high level or rise further.

  Mitigation: consultations with the government in close cooperation with DG ECFIN. Follow up of the IMF dialogue with Ukraine.

Before the signature of the Financing Agreement the sector strategy, the PFM reform strategy/ action plan and the macroeconomic stability will be duly re-assessed.

3.4. Stakeholders

The main beneficiary for the Programme is the Ministry of Energy and Coal Industry of Ukraine that is in charge of the state governance and state policy in the sector. Other stakeholders also cover: Ministry of Economic Development and Trade, Ministry of Finance, National Energy Regulatory Commission, Ministry of Ecology and Natural Resources.

Key non-state actors in the energy sector are Ukrainian and international business, including through business organisations such as the European Business Association, as well as civil society organisations monitoring implementation of government's policy in the sector. The donor community active in the energy sector in Ukraine includes WB, EBRD, EIB, KfW, USAID, GIZ, UNDP.

3.5. Crosscutting Issues

The proposed programme has no identified direct impact on human rights and gender equality. Broad public discussion on necessary improvements to emissions of large combustion plants and to fuel quality will strengthen transparency, public accountability, environmental awareness and civil society involvement. The market reforms addressed in the general conditions for disbursement will enhance the macroeconomic stability of Ukraine and should foresee proper customer protection mechanisms that will contribute to equal opportunities of all social groups in Ukraine. Without such measures families and pensioners would be hard-hit which would have a disproportionate effect on women.

Oil stocks improvements will bring the benefit of increased national energy security and will make Ukraine less vulnerable to external oil supply and price shocks which would affect the weakest sections of society most.

In addition, institution building activities as well as energy market reforms which are part of the programme are aimed to enhance transparency and good governance, thereby eliminating the grounds for potential corruption in the sector, as well as to mainstream environmental policies in the sector indirectly leading to strengthening the human rights and gender equality.

Reduction of the environmental pollution related to the energy sector is one of the programme's specific objectives.

Ukraine's membership of the EITI and fulfilment of its obligations is a sector governance issue and will be closely monitored.

4. IMPLEMENTATION ISSUES

4.1. Method of implementation

The programme is an untargeted budget support under direct centralised management for an amount of EUR 45 million with three variable tranches to be disbursed in 2014, 2015 and 2016. Funds will be disbursed directly to the account of the treasury of the government of Ukraine. In line with its budget procedures, the government of Ukraine will establish a decision for the receipt and use of budget support funds received.

Provision for the accompanying measures to the budget support programme through technical assistance is not included in the present programme. But such assistance can be made available under the AAP 2012 and future AAP 2013, subject to a duly justified request from the government. It could be focused to assist the government with implementation of the programme (including its monitoring and reporting) as well as with the implementation of the energy market reforms, in particular through implementation of EnCT commitments.

Provision for the programme visibility, evaluation, audit, etc. for the maximum amount EUR 0.5 million will be made available separately in the AAP 2012 budget for TA/Twinning.

4.2. Procurement and grant award procedures

(1) Contracts

Not applicable.

(2) Specific rules for grants

Not applicable.

4.3. Budget and calendar

Budget support (maximum):	€	45 million

Indicative Disbursement Calendar (EUR million)

Instalments	First	Second	Third
Indicative assessment	Quarter 4 of 2013 (or immediately upon signature of Financing Agreement)	Quarter 4 of 2014	Quarter 3 of 2015
Indicative disbursement	Quarter 1 2014 (or immediately upon signature of Financing Agreement including time for assessment of the Government's request for disbursement)	Quarter 1 of 2015	Quarter 1 of 2016
Variable tranches (max)	15	15	15

The budget support will be disbursed in three variable tranches of EUR 15 million maximum each. Variable tranches to be released are subject to the achieving of indicators, to be agreed with the main partners. Implementation will be monitored by a Joint Monitoring Group, to be supported if necessary with ad-hoc technical assistance (funded from other action programmes under AAP 2012 and/or AAP 2013).

The exact amount of the variable tranches, as well as an indicative calendar and tentative breakdown of payments shall be specified in the Technical and Administrative Provisions of the Financing Agreement, based on the consultation process between the EU and the Government of Ukraine.

The programme will be implemented within 36 months following the entry into force of the Financing Agreement.

4.4. Performance monitoring and criteria for disbursement

Performance monitoring will be exerted by a Joint Monitoring Group to be led by the Ministry of Economic Development and Trade or Ministry of Energy and Coal Industry of Ukraine. The Joint Monitoring Group will rely on official information provided by Ukraine and verify as appropriate. The Joint Monitoring Group will meet at least twice a year at technical level. High level meeting of the Joint Monitoring Group should take place at least once a year, including in the beginning and at completion of the programme. Additional mid-term meeting at high-level could be convened in case of the need to introduce changes in the policy objectives.

Disbursements of all tranches will depend on meeting general conditions related to a stable macroeconomic environment, progress in PFM reforms, progress in the reform of the energy policy including adoption and continuous implementation of the key instruments (energy part of the Association Agenda or Association Agreement, MoU in the field of energy, ERP and its action plans, revised Energy strategy), progress in the achievement of the EITI status and progress with gradual economic viability of energy prices while protecting vulnerable customer groups. The first variable tranche will be made dependent on a limited number of key issues such as the adoption of a sound Energy Strategy, based upon wide consultations, and adequate progress in the drafting and adoption of an Action Plan for its implementation, as well as demonstrated support to inclusion of the Oil Stocks Directive into the Energy Community *acquis*, and adequate action regarding fuel quality enforceability. Performance monitoring of specific conditions and disbursement criteria of the variable tranches will focus on the areas listed in article 3.2 of the Action Fiche.

The disbursements will therefore depend on the degree of compliance with the general and specific conditions stipulated in the Financing Agreement. Amount of the variable tranches will be decreased in case of partial compliance or non-compliance, in proportion of the weight specified in the Financing Agreement for each condition. Assessment on the degree of compliance with the general and specific conditions will be done by the Delegation (with possible external support, if there is a need). In case where part of one variable tranche would not be disbursed, the corresponding funds may be transferred to the next variable tranche, being still subject to the fulfilment of the corresponding general and specific conditions.

4.5. Evaluation and audit

The programme will be subject to the regular monitoring by the Joint Monitoring Group. A specific mid-term independent review will be organised to, inter alia, review the validity of the monitoring system and performance indicators.

Assessment of the results achieved will be reviewed and decided by the European Commission. In carrying out such review, the European Commission will, as appropriate, use the technical advice of external consultants recruited by the European Commission to verify technical reports and data transmitted by the government of Ukraine. Programme evaluations and audits, whenever necessary, will also be decided and funded from EU technical assistance. Part of the TA may be used to enhance the local capacities for auditing the programme. Such activities will be funded from other action programmes under AAP 2012 and/or AAP 2013.

4.6. Communication and visibility

The programme will follow the orientations of the Communication and Visibility Manual for the EU External Actions (e.g., press release at the signature of the FA, visibility for reports and studies, etc).

Proper communication and visibility of the action will be achieved via regular joint communication events on the occasion of the achievement of the disbursement criteria.

Communication and visibility activities will be funded from other action programmes under AAP 2012 and/or AAP 2013.