

**PROJECT INFORMATION DOCUMENT (PID)
IDENTIFICATION/CONCEPT STAGE**

Report No.: PIDC46978

Project Name	SUPPORT TO EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE COMPLIANCE PROCESS PROJECT
Region	EUROPE AND CENTRAL ASIA
Country	Ukraine
Sector(s)	Oil and gas (100%)
Theme(s)	Other accountability/anti-corruption (50%), Participation and civic engagement (30%), Other environment and natural resources management (20%)
Lending Instrument	Lending Instrument
Project ID	P158379
Borrower Name	Ministry of Energy and Coal Industry of Ukraine
Implementing Agency	Ukraine EITI MSG
Environment Category	C - Not Required
Date PID Prepared	15-Dec-2015
Estimated Date of Approval	15-Dec-2015
Initiation Note Review Decision	The review did authorize the preparation to continue

I. Introduction and Context

Country Context

Ukraine is facing political and economic challenges. Following the “Maidan” uprising that led to the ousting of the previous President in November 2013, calendar year 2014 saw several important events: Presidential elections in May; Parliamentary elections in October; and conflict in the East. In March 2014, the Autonomous Republic of Crimea and the City of Sevastopol held referenda to join the Russian Federation. The new Government that took office in December 2014 has a mandate for reforms but faces formidable challenges such as: containing conflict and restoring peace in the East; ensuring macroeconomic stability; tackling a major banking crisis; reducing the fiscal deficit in the midst of a recession without triggering social unrest or backlash against reforms; and reducing deep-seated corruption while contending with powerful vested interests that continue to oppose reforms.

In 2014, the government initiated a macroeconomic adjustment but economic performance remained weak despite efforts to stabilize the economy. Due to the ongoing adjustment and the escalating conflict, GDP declined by 6.8 percent in 2014. The currency depreciated by about 50 percent in the same year, which together with increases in utility tariffs, pushed the 12-month consumer price inflation to 24.9 percent y/y at the end of 2014.

The ongoing conflict caused significant contraction of industrial production in the East of Ukraine, broken supply chains and distorted economic ties with the Russian Federation. The connectivity

with the center and West of the country has, therefore, gained increased importance for reinvigorating the economic activity in the Eastern and Southern regions of Ukraine and ensuring greater resilience to the conflict.

The unfavorable global economic environment and conflict in the East led to a 16 percent decline in real GDP in the first half of 2015. Deterioration in Ukraine's terms of trade due to a drop in global commodity prices, re-escalation of the conflict in the East in the beginning of 2015, and macroeconomic adjustment led to a reduction in real GDP of 17.2 percent and 14.6 percent in the first and second quarters respectively. The decline was broad based: industrial production declined by 20.5 percent and retail trade by 25 percent in the first half of 2015.

Economic activity stabilized from July 2015 with GDP decline slowing to 7 percent in the third quarter. High frequency data indicates that the tentative stabilization continues in the fourth quarter: decline in industrial production and in trade gradually slowed to 5.0 percent and 16.7 percent y/y in October, respectively. Currency depreciation and a one-off utility-tariff adjustment accelerated inflation, which peaked at 60.9 percent y/y in April and declined to 46.4 percent y/y in October. Meanwhile, fiscal consolidation stabilized the general government headline deficit outperforming the IMF program target. After a sharp depreciation in early 2015 followed by administrative restrictions on imports, the current account is nearly balanced since April. Net capital outflows persisted, driven mainly by external debt payments in excess of official financing flows. This helped to rebuild international reserves that cover 3 months of imports as of early November. In November 2015, Ukraine successfully restructured a major part of its external debt in the amount of US\$15 billion having achieved a US\$3 billion debt reduction and 8.5 billion saving in principal repayments falling due during the next four years. Russia did not participate in the debt restructuring, insisting that Ukraine repay a US\$3.0 billion bond maturing in December 2015.

Despite early signs of stabilization, economic prospects for Ukraine depend on how the conflict in the East unfolds and whether the authorities are able to sustain reforms in an uncertain environment. Real GDP is projected to contract by 12 percent in 2015, with sharp declines in metals and mining sectors as they are affected both by the conflict and weakening external demand. However, the currency depreciation would support net exports and a gas tariff increase coupled with improved spending efficiency should create fiscal space to unlock government investment going forward. In addition, continued resolution of problems in the banking system could permit gradual resumption of lending. These factors, along with a low statistical base, are expected to set the stage for a modest economic recovery, with real GDP growing 1 percent in 2016 and 2 percent in 2017.

The crisis threatens to reverse some of the gains Ukraine made in earlier years in reducing poverty and boosting shared prosperity. Against the backdrop of negative growth and high inflation, real wages and pensions have declined, thus reversing gains made earlier in income levels, particularly among the less-well off. This decline was only partially offset by social-assistance reforms aimed at better targeting existing benefits, while deteriorating labor-market conditions aggravated these trends. In the first quarter of 2015, the unemployment rate increased to 9.6 percent (from 9.0 percent a year earlier) and real wages declined by 21 percent. This decline is uneven across sectors, with the lowest nominal-wage growth in the public sector, particularly in health, education, public administration, and defense (which employ approximately 28 percent of those employed among the bottom 40 percent in the income distribution). All these factors combined led to an increase in the moderate poverty rate from 3.2 percent in 2013 to 5 percent in 2014. The moderate poverty rate is expected to double to 10.2 percent in 2015. And even if the modest recovery anticipated in 2016

and 2017 materializes, the poverty rate would remain above its 2014 levels.

The IMF approved a four-year Extended Fund Facility (EFF) of US\$17.5 billion in March 2015. This EFF can provide Ukraine with the opportunity to reform its economy, restore stability and lay the basis for growth over the medium term. Policies targeted under the IMF's EFF and supported by the World Bank's two Development Policy Loans (DPL) include:

- a) Decisive structural reforms, including (i) broad energy reforms, including the restructuring of Naftogaz to strengthen corporate governance and promote energy efficiency and energy independence; (ii) ambitious end-user tariff increases; (iii) reforms of state-owned enterprises to improve corporate governance and reduce fiscal risks; and (iv) governance reforms, including anti-corruption and judicial measures, deregulation and tax administration reforms;
- b) Securing of financial stability, focused on (i) strengthening banks through recapitalization, reduction of related party lending and resolution of impaired assets; (ii) exchange rate flexibility to protect the economy against external shocks; and (iii) strong monetary policy to restore prices stability; and
- c) Strengthening of public finances, through (i) an expenditure-led adjustment to support fiscal consolidation over the medium term; and (ii) revamped social protection schemes to protect the poorest households.

Despite the disbursement of the second EFF tranche in August 2015, external and public financing risks remain significant.

Sectoral and Institutional Context

Ukraine has significant natural resources and plays a crucial role as a transit country for Russian natural gas exported to Western Europe. Natural gas exploration and production in Ukraine started in 1912 and first exports of natural gas were made to Poland in 1945. Ukraine has significant natural resources and plays a crucial role as a transit country for Russian natural gas exported to Western Europe. Oil and gas resources are concentrated in three regions: the Carpathian region in the west, Dnipro-Donetsk region in the east; and Black Sea-Azov Sea region in the south. The Dnipro-Donetsk region in the east accounts for 80% of proven reserves and approximately 90% of gas production. Based on the estimates of the Government of Ukraine, Ukraine's hydrocarbon reserves are 9 billion tonnes of oil equivalent (toe). Natural gas reserves are estimated at 5.4 trillion cubic metres (Tcm) with proven reserves of 1.1 Tcm of natural gas, more than 400 Mt of gas condensate and 850 Mt of oil reserves.

Ukraine also has considerable mineral resources being one of the world's top 10 leading producers of a number of minerals including: iron ore, steel, rutile, titanium sponge, manganese ore, and ilmenite. Ukraine also has abundant coal reserves ranking Ukraine sixth in the world for hard coal reserves, after the United States, China, Russia, Australia and South Africa. Most of the coal reserves in Ukraine are located in the Donetsk Coal Basin in eastern Ukraine in the regions of Donetsk, Luhansk and Dnipropetrovsk. There are two other basins, the Lviv-Volyn Coal Basin in western Ukraine and the Dnieper Coal Basin in central Ukraine.

Restructuring and upgrading the energy sector continue to be the key development challenges for the Government of Ukraine (GoU). Ukraine is among the world's top-10 energy intensive economies. In addition, Ukraine is one of the most energy-inefficient countries in the region. The

sector faces serious challenges in maintaining the security, reliability, and quality of supply due to delays in energy sector reform, the poor financial condition of energy sector enterprises, a lack of investments, and deferred maintenance of aging infrastructure.

Ukraine has recently taken active steps in demonstrating its commitment to reform and enhanced transparency in the energy and extractives sectors. Commitment to the Extractives Industries Transparency Initiative (EITI) implementation is an integral part of the much broader reforms that the country needs to undertake to eliminate corruption, poor governance, lack of transparency and accountability in the sector and create the favorable business climate, foster investments and ensure competitiveness of the energy market. Critical reforms include:

- (i) Comprehensive reform of gas and extractives sector and the power sector to ensure compliance with the European Third Energy Package and attracting much needed investments in modernization and rehabilitation of the sector; Recently adopted gas market law focuses on de-monopolization of the Ukrainian gas sector towards the creation of a competitive gas market, and offers consumer protection;
- (ii) Bringing energy tariffs to cost recovery level while ensuring improved social targeting to effectively offset impact of tariff adjustments on low-income consumers; and
- (iii) Facilitating the regulatory environment and financial mechanisms towards increasing energy efficiency.

Ukraine's commitment to EITI is reflected in the new Government's Coalition Agreement. Companies operating in the extractives sector are predominantly state owned. The privately owned companies are mostly owned by large industrial and business conglomerates. The extractives sector in general has been characterized as very nontransparent with inadequate and hard to access information on actual production or operational figures, levels of subsidies and ownership structure.

Civil society in general is very active but so far has had limited influence in acting as an effective watchdog of public financial management. Civil society organizations (CSOs) have been very active in pushing for the implementation EITI in Ukraine. Since late 2010 CSOs organized a number of conferences for capacity building and awareness raising for EITI. These events were followed-up with two other conferences on the implementation of EITI in Ukraine organized in 2012 and 2014 by the Ministry of Energy with support from the World Bank. All these public events were crucial for raising awareness on the importance of the implementation of EITI in Ukraine and building the basic capacity for kick-starting broader public discussions on transparency in the extractives sectors. Civil society's EITI advocacy is responsible for some reform activity. For example, the Cabinet of Ministers' adoption of the Decree on Ukraine's Accession to the EITI. Minister of Energy and Coal Industry (MOECI) was appointed as the leader for implementation of EITI by the Cabinet of Ministries. The Multi-Stakeholder Working Group (MSG) for EITI in Ukraine was established on October 11, 2012. Ukraine is now an EITI candidate country with the first EITI report being published in December 2015.

Relationship to CAS/CPS/CPF

The implementation of EITI could support the Government of Ukraine's (GoU) efforts for improving governance and enhancing transparency in the mining and oil and gas sectors. Through the implementation of EITI, the government can demonstrate its adherence to an internationally recognized standard and practices of good, open and responsible corporate governance. Greater transparency in production data, licenses, and payments and revenues can boost prospective

investors' confidence and enhance competition. This could support Ukraine in consolidating its credibility with international public and private partners.

The proposed project is in line with and supports the World Bank Group's Country Partnership Strategy (CPS) for Ukraine (FY12-16) (Report No. 66279-UA). Outcome 4 of the CPS, "Improved governance in the energy sector", amongst others, supports Ukraine's efforts for implementing EITI. This project will provide direct support for the implementation of the EITI in Ukraine with the objective of enhancing the overall transparency in the extractives sectors.

By helping Ukraine implement its EITI agenda, the proposed activity would be a small but important element in support of the Bank's partnership with Ukraine. The Bank supports Ukraine on its difficult reform path, through a number of activities including an EU funded technical assistance for the restructuring of NAK Naftogaz, to assist in unbundling of this major state enterprise and improving its financial management. Bank projects support Ukraine's power, hydropower, district heating sectors in modernization of its infrastructure, increasing energy efficiency and improving its governance. In the framework of a DPL in early 2015, the Bank assisted Ukraine in developing legislation enabling reforms, and in moving towards more independent and professional energy sector regulatory body. Further under the DPL, the Bank assisted in developing a Gas Sector Reform Implementation Action Plan and will continue supporting its implementation going forward through intensive technical assistance (TA) and policy advice.

II. Project Development Objective(s)

Proposed Development Objective(s)

The project development objective is to assist the Government of Ukraine in implementing the EITI agenda

Key Results

Progress in achieving the PDO will be measured by the following key results indicators:

- a) Improved transparency in the extractive industries as measured by the completion of EITI Validation in Ukraine.
- b) Enhanced capacity of the Ukraine EITI MSG to manage the EITI compliance process, measured by an increased percentage of total revenues reconciled in the EITI reports.
- c) Improved capacity to communicate on issues associated with transparency and accountability in the extractive industries measured by increased reporting in the media by journalists compared to the previous year.

III. Preliminary Description

Concept Description

Following an extensive advocacy effort led by local civil society organizations, the Cabinet of Ministers of Ukraine passed a resolution "on Ukraine's accession to the EITI" on September 9, 2009. Ukraine was admitted as an EITI candidate on 17 October 2013 after successfully completing the four "sign-up" steps including the development of a work plan, which was validated by the EITI Board. Ukraine as required to publish its first EITI report by October 17, 2015 with the objective to become compliant by October 2016.

Given that enhancing transparency and accountability represents a substantial challenge in the country, the MSG that was formed in 2012 decided to be carefully optimistic about what it could

realistically achieve and limited the coverage of the first EITI report to the oil and gas sector, while the second EITI Report would be extended to mining. The publication of EITI Reports that “include contextual information about the [overall] extractive industries” (requirement 3) and are “comprehensive [and] include full government disclosure of extractive industry revenues, and disclosure of all material payments to government by oil, gas and mining companies” (requirement 4) are requirements for EITI compliance. Ukraine will, therefore, have to publish its second EITI report before the validation period starts on October 17, 2016.

Soon after its admission as a candidate country, however, Ukraine experienced a prolonged political and economic crisis. The EITI process was understandably delayed but kept moving forward. The MSG continued to meet reasonably regularly throughout the crisis and instead of seeking a voluntary suspension, opted to move ahead with preparations for EITI Reporting, in the hope that the reporting process could begin quickly once the political situation stabilized.

Despite the challenging geopolitical context, substantial progress has been made with the EITI process in Ukraine. On 16 June 2015, the Parliament of Ukraine adopted Law No. 521-VIII “On Amending Certain Laws of Ukraine with Respect to Strengthening Transparency in Extractive Industries in Ukraine” (the “Law”) mandating the participation of all relevant parties in EITI reporting. The Law was approved by the President and came into force on 12 July 2015. The Ministry of Energy and Coal Industry has also developed bylaws specifying the scope of EITI reporting, entities required to participate, and the implications of non-participation. These bylaws are expected to be adopted by the Cabinet of Ministers by the new calendar year. The laws were prepared to enable the disclosure of financial information and business activities of Ukrainian extractive companies ahead of the submission of the EITI report due by 17 October 2016. As a result of the bylaws still not being adopted, the Independent Administrator in charge of developing the first EITI Report for Ukraine experienced difficulties in collecting data from several major players such as the State Fiscal Service and Ukrnafta. The Ukraine MSG, therefore, decided to request a deadline extension for the publication of the first EITI Report to ensure that it would be as comprehensive and meaningful as possible. The request for extension was granted by the EITI Board on December 4 2015.

While the preparation of the first EITI report necessitated substantial effort and demonstrated a strong leadership and commitment from the Ukraine MSG, the challenges ahead are significant. The first EITI report was published on December 4, 2015. To ensure the publication of a second EITI report, covering all extractive industries by October 2016, much effort will be needed to allow the Ukraine MSG to (i) communicate extensively and effectively on the EITI requirements and process, (ii) engage all relevant stakeholders in the EITI process by providing them with enhanced capacity, and (iii) build the analytical and legal work needed to underpin the reform agenda associated with the EITI compliance process. The proposed grant is meant to support these critical efforts, the publication of the next EITI reports and other key activities needed to ensure the sustainability and mainstreaming of EITI in Ukraine.

Project Components

The proposed grant would be a follow-on grant to an EITI MDTF grant (Ukraine EITI Implementation Support Project, P128405) which financed the establishment of Ukraine’s national EITI Secretariat and the first EITI report’s preparation and dissemination. The proposed grant is meant to push EITI implementation in Ukraine forward and support critical efforts needed to help

the country reach EITI compliance. A follow-up grant is needed to ensure the sustainability and mainstreaming of EITI in Ukraine. The signing of key contracts under the proposed project will be needed to trigger access to a follow-on grant.

Component A: EITI Implementation Support (US\$ 175,000). This component will support the activities essential to EITI implementation and meeting Ukraine's obligations as an EITI candidate country to reach compliance. These activities include:

- Annual EITI reports for Ukraine (US\$ 150,000). Recruitment of an Independent Administrator (IA) in charge of the preparation of one EITI report covering all extractive industries for the calendar years 2014 and 2015.
- Sub-committees and regional MSG meetings (US\$ 25,000). Costs of meetings of the sub-national coordination units recently created by the MSG to broaden involvement in the EITI process and regional MSG meetings for the first year of implementation.

When additional Extractives Global Programmatic Support (EGPS) financing becomes available to Ukraine, a follow-on project will be prepared with the objectives to use the funds to finance: (i) sub-committee and regional MSG meetings for the second year of implementation (US\$25,000); (ii) a review of the legal and regulatory framework of the extractive industries including a needs assessment for additional policy, reform or investment. The review and needs assessment, and any underpinning work would be prepared in compliance with and taking into account the Bank's safeguards and related operational policies. (US\$ 400,000); and (iii) a feasibility study for setting up an integrated government system for generating EITI data more efficiently (US\$300,000).

Component B: Capacity Building Activities (US\$ 75,000). Building on lessons learnt from the preparation of the first report, it will be important to help operators and state agencies better understand the EITI requirements. Under this Component, the project will thus support advisory services for state agencies and companies operating in the extractives industries to comply with EITI requirements.

When additional EGPS financing becomes available to Ukraine, the funds will finance: (i) additional training to deepen Ukraine EITI MSG and National Secretariat knowledge of issues associated with resource management (US\$ 75,000); (ii) core training on EITI and natural resources management tailored for all relevant stakeholders government officials, parliamentarians, companies operating in the Extractives Industries (EI), civil society (including NGOs, the media, and youth) on matters related to the extractive industries, EITI Standard, and overall transparency in the sector (US \$ 50,000); and (iii) tailored training to investigative journalists on reporting on EI and EITI (US\$ 50,000).

Component C: Communication and Outreach (US\$ 60,000). This component will support the implementation of the Ukraine EITI Communication Strategy for the first year of project implementation and will include the following activities:

- Print and visual media outreach campaigns (US\$ 25,000). Support for the EITI National Secretariat to publish and disseminate crucial information on EITI implementation through radio, TV, and print media outreach campaigns, in order to inform the public on the overall extractives industry, EITI implementation and related events;

- Organization of awareness raising events (US\$ 30,000). Round tables, press conferences, conferences, workshops will be organized to increase the overall understanding of the key issues in the management of the extractives sectors.
- Internet and social media activities (US\$ 5,000). Support for the management of a Ukraine EITI website and social media accounts that contains information specifically related to the EITI implementation in Ukraine as well as wider information on activities related to transparency of extractive industries in Ukraine, as well as global news and trends on EITI implementation experiences from other countries.

When additional EGPS financing becomes available to Ukraine, the funds will be used to finance a second year of implementation.

Component D: Project Management (USD\$ 90,000). This component will support the costs of the EITI National Secretariat staff (National Coordinator of the Secretariat, Financial, Procurement and Public Relations Consultants) and provide support for the operating costs of day to day activities carried out by the EITI Secretariat, under the oversight of the MSG. GoU covers the costs of office space and associated utility costs, while the grant will cover the operation costs associated including office supply, travel costs related to the work of the Secretariat and of MSG members, office maintenance, internet, phone, banking charges.

While the cost described above will be covered for one year of project implementation, another year of implementation could be financed when additional EGPS financing becomes available to Ukraine. Triggers will be added to the project paper for the completion of specific actions during this phase before financing for the next phase kicks in.

IV. Safeguard Policies that Might Apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
Environmental Assessment OP/BP 4.01		x	
Natural Habitats OP/BP 4.04		x	
Forests OP/BP 4.36		x	
Pest Management OP 4.09		x	
Physical Cultural Resources OP/BP 4.11		x	
Indigenous Peoples OP/BP 4.10		x	
Involuntary Resettlement OP/BP 4.12		x	
Safety of Dams OP/BP 4.37		x	
Projects on International Waterways OP/BP 7.50		x	
Projects in Disputed Areas OP/BP 7.60		x	

V. Financing (in USD Million)

Total Project Cost:	0.4	Total Bank Financing:	0
Financing Gap:	0		
Financing Source			Amount

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