

**UKRAINE – Second Programmatic Adjustment Loan
(Loan No. 4722-UA)
Release of the Second Tranche and Request for Waiver**

Tranche Release Document

I. Recommendation

1. Ukraine (the Borrower) has met all but two conditions for release of the second tranche of the Second Programmatic Adjustment Loan (PAL-2). A waiver is sought on the condition contained in paragraph 2 of Schedule 3 of the Loan Agreement: “The Borrower has continued to improve the payment discipline in the electricity and gas sector through the satisfactory implementation of debt resolution, as evinced by: (i) the adoption by the Parliament (*Verkhovna Rada*) of a comprehensive law on debt resolution in the energy sector; and (ii) the obligatory participation of enterprises, in which the state has a controlling share, in the debt resolution mechanism established by the said law.” A partial waiver is sought on the condition of paragraph 6 (i) of Schedule 3 of the Loan Agreement with regard to the engaging of the financial advisor for the privatization of a group of remaining state-owned *Oblenergos* (power-distribution companies) and the launching of the corresponding privatization tender. These waivers are recommended on the grounds set forth in paragraphs 20-21 of this tranche release document. In view of the performance in implementing the Program supported by the Loan, it is recommended to release its second tranche in the amount of USD 172.5 million.

II. Background

2. The Programmatic Adjustment Loan Program (PAL) was developed with the Government of Ukraine in 2001. PAL was envisaged as a series of three loans totaling US\$ 750 million in support of the government’s program of institutional and structural reform. It is designed across five thematic areas: (a) financial discipline, (b) regulatory reform, (c) protection of property rights, (d) public sector accountability, and (e) management of social and environmental risks. The first PAL of US\$250 million was approved by the World Bank Board of Executive Directors in September 2001. It was disbursed in two tranches, of US\$150 just after Board approval, and a second tranche of US\$100 on December 7, 2001 upon completion of 2nd tranche benchmarks. PAL-1 included indicative benchmarks for the proposed PAL-2 and PAL-3 operations.

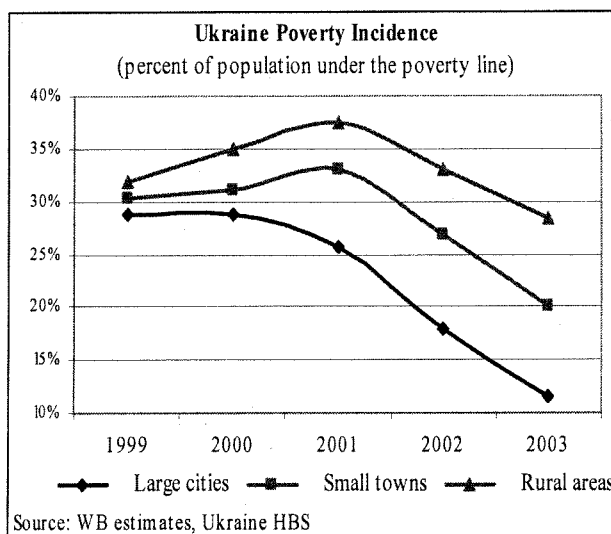
3. The PAL program was designed to disburse in sequence with completion of concrete achievements on the institutional and structural reform program of the government. Preparations for PAL-2 began in January 2002, and it was approved by the Board in December 2003. A first tranche of US\$ 75 million was disbursed on December 19, 2003 based upon completion of the pre-Board benchmarks.

4. The Government and the Bank have completed negotiations on a proposed First Development Policy Loan (DPL-1) program, which would carry forward the PAL agenda in the context of the new government program.

III. Recent Developments

5. **Political Developments:** The 2004 Presidential Elections represent significant political change. Mr. Viktor Yushchenko was elected President with a clear mandate to integrate Ukraine with Europe and fight corruption. He has committed to undertake the necessary legal and political changes to improve the welfare of Ukraine's citizens by establishing broad-based social and economic development. President Yushchenko's nominee to the post of Prime Minister, Ms. Yulia Tymoshenko, was confirmed by the Verkhovna Rada on February 1, 2005. Her Government's program is designed to uphold this mandate by implementing the policy, institutional and structural reforms necessary to bring it to fruition.

6. **Economic Developments:** During the PAL period, Ukraine improved its macroeconomic and fiscal framework and experienced strong economic growth and poverty reduction. In the years since the 1998 regional financial crisis, improvements in financial discipline, fiscal and monetary policies, current account adjustment (supported by a weak real exchange rate), regional growth trends, and improvements in the business climate have resulted in strong GDP growth totaling 50% for the period 1999 through 2004. The highest growth measured over this period occurred in 2004 when GDP growth of 12.1 percent was spurred by further improvements in the terms of trade and pre-election fiscal expansion. High growth over the post 1998 period led to significantly lower poverty incidence, which declined from over 30 percent in 1999-2001 to 19 percent in 2003, and is expected to have fallen further in 2004. However, a rural-urban divide remains, and some groups of the population are especially vulnerable, especially children in large families, the elderly and the disabled.



7. The public debt to GDP ratio has declined. Primary fiscal surpluses of 0-2 percent GDP during 1999-2003 have helped to reduce the public and publicly guaranteed (PPG) debt (incl. IMF credit) ratio from 61 percent GDP in 1999 to 25 percent GDP in 2004.

8. During the last 5 years, Ukraine's current account has been in surplus, and the National Bank of Ukraine (NBU) has accumulated substantial foreign exchange reserves which now exceed the value of 4 months of merchandise imports. Continuing recent trends, strong external demand and improvements in the terms of trade, in particular high world prices for steel, resulted in a record current account surplus of 10.4 percent of GDP in 2004. Until recently, the NBU maintained a policy of *de facto* fixing of the hryvnia against the US dollar at around 5.3 UAH/USD. In 2003-2004, the hryvnia depreciated in real terms due to higher inflation in Russia, and the Euro appreciation against the US dollar.

9. The resilience of the macroeconomic framework was tested by the political crisis during the presidential election. Households' loss of confidence during the election process resulted in exit from hryvnia holdings, resulting in pressure on the international reserves of the NBU, which declined by almost USD 3 billion. However, sound monetary policy and

banking sector management during the political crisis, and the strong fundamentals outlined above, were sufficient to avoid a financial crisis. The situation in the banking sector stabilized as soon as the political crisis was resolved, evinced by a recovery in reserves, the exchange rate, interest rates, and inter-bank liquidity.

10. The new authorities inherited unbalanced public finances. The 2005 State Budget Law, adopted in December 2004, envisioned a general government deficit of 2.1% GDP. But this deficit figure did not account for all expenditures, including the legislated increase in minimum pensions to the level of the subsistence minimum which was enacted by the Cabinet of Ministers in September of 2004, and enacted through legislation in December 2004. Simulations suggested that without adjustments, the deficit of the general government would in fact have increased closer to 7 percent of GDP.

11. As a priority measure, the new Administration has revised the 2005 Budget through parliamentary approval on March 25, 2005, and reduced the targeted consolidated deficit to 2.2 percent of GDP. While President Yushchenko has made it clear that the new administration would keep the social promises legislated late last year, the Government has responded to the fiscal gap by enhancing revenue measures and containing expenditure growth. Revenue measures include: (a) eliminating most tax exemptions, (b) increasing excise taxes for fuel and alcohol, (c) charging higher rents for extractive industries, (d) significantly lowering import some tariffs, and (f) seeking to improve SOE management through profit incentives and associated higher profit transfers to the budget. There is also a broad effort to transfer shadow economic activity to the formal economy through better leadership and reduced corruption, especially within revenue authorities. On expenditures, the Government has taken early steps toward addressing the pension problem, including rebasing privileged pensions on their real levels at the time of the 2003 pension reform, and indexing pensions only to CPI (not to CPI plus 20 percent of the nominal average wage increase in the economy).

12. Early indications are positive in terms of tax revenue collections. In the first quarter of 2005, the revenues of consolidated (state and all local) budget grew, in real terms, by 28 percent year-on-year, especially from increased VAT (up by 51 percent year-on-year) and the corporate profit tax (up by 34 percent year-on-year). However, the high net VAT collections data overstates progress; gross VAT collections were up by 28 percent only in real terms, while VAT refunds declined by 14 percent. The State Tax Administration (STA) insists that reductions in VAT refunds are due to technical and legal reasons, and the problem will be addressed. The still substantial revenue increases may reflect a permanent reduction of the shadow economy, particularly through changes in the management of Customs and the State Tax Administration, or it may reflect a more temporary, risk averse behavior of tax inspectors, customs officials and entrepreneurs, which will not be preserved without improved technical administration to permanently stop corruption.

13. In response to inflationary pressures, the Authorities have started to re-align the exchange rate. On April 20, the NBU slowed its purchases of the net inflow of dollars, allowing a one-off shift of the de facto peg to 5.05 hryvnia per US dollar. This moderate exchange rate realignment has helped establish the basis to move toward a floating rate in the context of the plan to move to inflation targeting. The exchange rate realignment will help to reduce inflationary pressures through a number of channels: lowering prices of imported goods, reducing the current account surplus, and lowering the relative value in hryvnia of net inflows of foreign exchange. These factors will help reduce money supply growth while reducing opportunities for currency speculation.

14. Policy coordination is improving. The Prime Minister has explained benefits of the NBU's stance on revaluating the exchange rate, while noting the independence of the NBU. At parliamentary hearings after the exchange rate realignment, the Minister of Finance supported the move by the NBU. In April, the Minister of Finance managed to reduce the costs of debt service and helped the NBU to sterilize the money supply through buy-back of the government debt held by the NBU. The Letter of Development Policy (LDP) dated November 12, 2003 recognizes the importance of macroeconomic stability (see Annex 1). It expresses the aim to strengthen the macroeconomic policy framework through adjustment of monetary and exchange rate policies, impose more stringent budget restraints on consumption expenditures – especially unsustainable recurrent transfers, eliminate uncertainty and excessive complexity in the tax system, and adopt clearer principles of government borrowing. The Government has indicated that it will take necessary corrective actions if macroeconomic stability is threatened.

15. The strengthened macroeconomic management is reflected in market optimism. The Ukrainian government has recently issued hryvnia-denominated Treasury bills with a maturity of one-year, yielding 4.5 percent. This represents a dramatic decline from T-bill rates one year ago, which exceeded 10 percent. The improved climate for government paper can be attributed to optimism for current and future economic prospects as well as perceptions of a substantial undervaluation of the currency. In May, Standard and Poor also upgraded Ukraine's sovereign credit rating from BB- to B+ reflecting, in good part, the improvements in economic management.

16. While the medium-term macro-policy agenda still needs to be more fully articulated, the new Government's active recognition of, and response to, the economic risks it inherited, and the well-established track record of strong economic growth, and stable macroeconomic indicators over the recent past, indicate that the macro policy framework is adequate for the second tranche of PAL-2 to proceed. To date, growth continues to be strong, debt is low and falling, and foreign reserves are at record levels. The Government has targeted a halving of the inherited budget deficit as a proportion of GDP. Fiscal performance through the first four months of 2005 is already ahead of ambitious targets. The authorities have introduced measures to combat inflation, liberalize the exchange rate, and strengthen overall macroeconomic management.

17. The authorities have indicated a willingness to engage with the IMF. The 12-month precautionary stand-by arrangement between the IMF and Ukraine expired in March 2005. A review of precautionary stand-by was not completed. In particular, the IMF noted procyclical amendments to the 2004 budget and weak legislation on connected lending in the banking sector. The Authorities have signaled general interest in a successor precautionary arrangement, but have not yet indicated a timeframe for discussion.

V. Progress under PAL-2

18. As was mentioned above, the PAL Program supports the Government's program of structural and institutional reforms articulated around five thematic cross-cutting areas, covering the following activities: (a) financial discipline; (b) regulatory framework; (c) property rights; (d) public sector accountability, and (e) management of social and environmental risks.

19. Overall, progress in program implementation has been significant with many important accomplishments, including improved financial discipline as evidenced by reduced

budget, tax and inter-enterprise arrears, an improved regulatory framework in the financial sector, further advance towards creation of conditions for Ukraine's accession to the WTO, particularly in areas of technical regulation and intellectual property rights, a strengthened system of budget execution and intergovernmental finance, establishment of a legislative and institutional framework for pension reform, better targeted social assistance and improved quality of social care. The Table below summarizes progress made under specific Board and second tranche release benchmarks, and thus represents a core sub-set of overall progress achieved under the Letter of Development Policy.

PAL-2 First and Second Tranche Benchmarks	Summary of Progress
Fiscal and Financial Discipline	
• Reduction of budget and tax arrears	Achieved
• Immediate reforms to improve financial discipline in the energy sector, through successful implementation of short-term plan, and adoption of a comprehensive long-term plans to bring the energy complex to financial solvency and attract investment	Achieved
• Improved payment discipline in energy sector through satisfactory debt resolution	Waiver proposed
Regulatory Framework	
• Improved legal and regulatory framework in critical sectors, including agricultural and financial sector	Achieved
• Progress toward WTO accession, including harmonization of technical standards system with EU requirements and development of legal framework in correspondence with the requirements of TRIPS	Achieved
Property Rights	
• Transformation of ownership and organizational structure in agriculture through enactment of the law which forms legal basis for establishment of a unified system of registration of legal rights to land and real estate within a single agency	Achieved
• Further progress in managing natural monopolies and encouraging private sector participation:	
(i) Engaging the financial advisor for the privatization of a group of remaining state-owned Oblenergos and the launching of privatization tender	Partial waiver proposed
(ii) Continued progress toward completion of an unqualified audit of the consolidated financial statements of Naftogaz for 2004, based on IFRS	Achieved
Public Sector Efficiency and Accountability	
Adoption of a Development Concept for the System of Internal Audit and Control according to EU standards.	Achieved
Introduction of more effective tax and revenue system through reduction of sector/industry specific tax exemptions and privileges	Achieved
Management of Social and Environmental Risks	
Progress in establishment of legislative, technical and institutional framework for pension reform	Achieved
Improved system of targeted social assistance	Achieved
Promote environmental compliance through a more efficient system of environmental regulation	Achieved

20. In addition to significant overall progress, the Borrower has surpassed the original benchmarks of the PAL-2 in a number of cases. These include, among the many areas of continued progress, on cash collections in gas and electricity, progress on development of EU technical procedures and adoption of voluntary product standards, enactment of the

legislative basis for a modern three pillar pension system, enactment of good laws on mortgage and secured interest, establishment of the institutional and enforcement basis to combat money laundering and financing of terrorists, measures to improve customs procedures, establishment of a communications regulator, and dramatic reduction of tax exemptions, from an already low base. Specific to the second tranche benchmarks, all legal conditions have been completed with the exception of condition set forth in paragraph 2, Schedule 3 of the Loan Agreement regarding enactment by the Verkhovna Rada of a comprehensive law on debt restructuring in the energy sector, and partially on para 6 (i), Schedule 3 of the Loan Agreement with regard to engaging of the financial advisor for the privatization of a group of remaining state-owned *Oblenergos* (power-distribution companies) and the launching of the corresponding privatization tender. The waivers are recommended on the basis of the following reasoning.

21. The Government has confirmed that it is committed to continuing energy sector reforms, and supported by PAL-2, has developed an ***Action Plan for Financial Recovery of the Fuel and Energy Sector***. This plan was approved by the Cabinet of Ministers on May 28, 2005 and published in the national standard. The plan calls for continued improvements in cash collections of energy services, reduction of cross-subsidization of tariffs, bringing tariffs to full cost recovery levels (including investment needs), better management of remaining state-owned companies in the sector, strategic industrial re-organization, and various options for additional private participation in the sector. The plan forms a basis for a strategic program to be developed for the overall energy sector. At the same time, the Borrower has requested a waiver on two related steps agreed under the PAL-2: (a) passage of a comprehensive debt restructuring law in the energy sector, and (b) launching of a tender for privatization of a group of power companies. A concept and draft law for debt restructuring has been prepared under the PAL-2 program, and is under consideration of the Fuel and Energy Committee in the Verkhovna Rada, where it has been approved for the second reading. While the new Government supports the goals and principles of the debt restructuring concept, it is reviewing the structure of the workout and write-off mechanisms as envisaged in the draft law. The Government has expressed its concerns about passage of a law, which will include debt write-offs for non-technical losses of the past, while allowing for partial payment of those losses with a tariff increase to consumers, in the run-up to the March 2006 parliamentary election. Debt restructuring is crucial prior to privatization, since the power companies in question have large debt overhang. In the context of the Government's concerns about the non-transparency of past privatizations in Ukraine, it plans to move forward on power privatization not earlier than the latter half of 2006, after the debt restructuring law is passed and under implementation, and in light of a new privatization program with a clearer focus on the transparency and quality of privatization of large state owned companies.

22. It is proposed to proceed with the PAL-2 second tranche of US\$172.5 million in the context of a new agreement on the proposed Development Policy Loan for Ukraine in which the energy sector objectives of the PAL program would be subsumed and achieved.

23. Detailed description of actions that have been taken to fulfill the second tranche legal conditions is given in the next section.

VI. Status of Release Conditions of the 2nd Tranche

Financial Discipline

Loan Agreement, Schedule 3, Paragraph 1. The Borrower has reduced the accumulation of arrears to the budget, by: (i) maintaining a no net increase in active tax arrears, without the use of tax amnesties, by the non-energy enterprise sector since January 1, 2002, and by the energy enterprise sector since January 1, 2003; (ii) carrying out a satisfactory implementation of the Short-term Action Plan; and (iii) adopting, through its Cabinet of Ministers and, thereafter, publishing in the official gazette of the Cabinet of Ministers (*Uriadovy Courier*), the Comprehensive Action Plan.

- (i) This condition has been met. According to the Government's official data, active tax arrears¹ without the use of tax amnesties, decreased from 0.9 percent GDP (UAH 1,916 million) as of January 1, 2002 to 0.3 percent GDP (UAH 1,250 million) as of April 1, 2005 for the non-energy enterprises. Tax arrears of enterprises in the energy sector, also without the use of tax amnesties, decreased from 3.5 percent GDP (UAH 7,941 million) as of January 1, 2003, to 2.2 percent GDP (UAH 8,082 million) as of May 1, 2005².
- (ii) This condition has been met. It has been agreed in the Minutes of Negotiations that the short term action plan to improve financial discipline in the energy sector should include the following points that will be implemented as triggers of second tranche release of PAL II: (a) submission to the Verkhovna Rada of the draft Law on Charging Penalties for Untimely Payment for Consumed Electricity, Gas and Communal Service, (b) local Governments legally obliged to compensate municipal companies for setting loss making municipal services tariffs, (c) an emergency reserve list of potentially environmentally hazardous enterprises, including the protected volume of electricity, is approved by the Cabinet of Ministers (CoM) and financing sources are identified for each of these enterprises, (d) procedures for compensating consumers of low quality or below billed provision of heating and water services are developed and made effective and (e) electricity payment and/or tariff privileges for individual business entities and/or sectors are prohibited with the exception of the tariff level for the communal service companies.
 - a) This sub-condition has been met. The law introducing the provision on charges for untimely payment for consumed electricity, gas and communal services has been submitted to the Verkhovna Rada and adopted on June 24, 2004.
 - b) This sub-condition has been met. Article 191 of the Economic Code that came into force on January 1, 2004, and article 31 of the Law of Ukraine "On Housing and Communal Services", No. 1875-IV, that came into effect in January 2005, require local executive authorities and local self-governments to compensate communal enterprises for the difference between established (fixed) tariffs and actual, economically justified costs, for services. Additionally, as a legislative harmonization step, the CoM submitted to the

¹ Active tax arrears are defined as tax arrears excluding, (a) penalties, fines and sanctions, (b) arrears of enterprises on which bankruptcy proceedings have been instituted and moratorium on collection by tax authorities has been imposed, (c) arrears of enterprises of a fictitious nature, and/or (d) against whose managers of which criminal proceedings have been instituted.

² Actual energy sector arrears as of May 1, 2005, were UAH 8,082 million as compared to UAH 7,941 million, as of January 1, 2003. The difference of UAH 141 million is marginal, relative to the margin of error of the official and best available data source, as a percentage of GDP (0.04 percent GDP), and relative to monthly energy sector tax payments (10% of average monthly payments so far in 2005). The level in nominal UAH represents the progress envisioned by the benchmark as a ratio to GDP.

Verkhovna Rada a draft law on Amendments to the Law on Prices and Pricing, which would bring the latter in conformity with the Economic Code.

- c) This sub-condition has been met. A resolution of the Cabinet of Ministers providing for creation of an emergency reserve list of potentially environmentally hazardous enterprises was adopted on December 26, 2003. This resolution creates a system by which harder budget constraints can be imposed on enterprises, which if shut down because of energy nonpayment, would create environmental hazard. The emergency reserve allows corrective action to be taken during a period covered by the reserve fund. In addition, Budget Law 2004 allocated UAH 37.0 million from the special fund of the State Budget to the Ministry for Emergency Situations to finance electricity reserve for enterprises in the emergency reserve list. This provision has been extended to the 2005 Budget Law.
- d) This sub-condition has been met. Procedures for compensating consumers for low quality or below billed provision of heating and water services have been established by the CoM Resolution dated December 30, 1997. In May 2004, the State Housing Committee developed a new version of the Procedures in compliance with the Law on Housing and Communal Services. These draft Procedures were agreed with the Bank, considered at the Government committee and approved at the meeting of the Cabinet of Ministers on January 19, 2005.
- e) This sub-condition has been met. By the beginning of 2004, all privileged tariffs had been eliminated with the exception of OJSC Zaporizhzhya Aluminum Plant and Zaporizhzhya Titanium and Magnesium Plant. These privileges were eliminated by CoM Resolution dated February 23, 2005.

(iii) This condition has been met. A satisfactory action plan has been prepared by the Government and in particular the Ministry of Fuel and Energy. This plan was prepared with the help of a consulting firm financed by the Verkhovna Rada, as well as local and international consultants financed through a Japanese Grant (PHRD) in support of the PAL program. The plan is well designed, comprehensive, reasonably sequenced, and already under partial implementation, including improved electricity and gas cash collections, and strengthening of governance in the sector. The plan has been agreed with the Bank, adopted by the Government, and was published on May 28, 2005. As agreed with the Bank, it was adopted by the Cabinet of Ministers as a working plan, subject to change on a rolling basis through the life of its implementation.

Loan Agreement, Schedule 3, Paragraph 2. The Borrower has continued to improve the payment discipline in the electricity and gas sector through the satisfactory implementation of debt resolution, as evidenced by: (i) the adoption by the Parliament (*Verkhovna Rada*) of a comprehensive law on debt resolution in the energy sector; and (ii) the obligatory participation of enterprises, in which the state has a controlling share, in the debt resolution mechanism established by the said law.

This condition has not been met, and a waiver is requested (see paragraphs 20-21 of this document). As was mentioned above, the Government has confirmed that it stays committed to further reforms in energy sector, including adoption of energy debt restructuring law and subsequent launching of the privatization tender.

Regulatory Framework

Loan Agreement, Schedule 3, Paragraph 3. The Borrower has improved the regulatory framework in the financial sector, by: (i) the satisfactory implementation of the agreed-upon schedule on phasing in of the Basel Core Principles for connected lending; (ii) taking adequate actions to enforce the procedures to ensure all bank external auditing is compliant with the International Standards of Auditing or the application of the appropriate sanctions within the powers of the NBU *in lieu* thereof; (iii) the continued progress in the satisfactory implementation of the Memorandum of Understanding; and (iv) the provision of adequate funding for the continued establishment of the SCRFSM.

- (i) This condition has been met. In line with agreement reached during the loan negotiations, as elaborated in Attachment 10 of the Minutes of Negotiations, in May 2004 NBU submitted proposed amendments to the Law on Banks and Banking to the parliament of Ukraine.³ These amendments have been agreed with Bank Staff, and upon enactment by the Verkhovna Rada, would establish the legal framework for improved corporate governance and transparency of banks and their ownership structure, thus allowing improved compliance and enforcement by the NBU of the Basil Core Requirement on connected lending. All of the respective NBU regulations have also been prepared, in agreement with Bank Staff, relevant to implementation of the revised banking law, as outlined in Annex 10 of the Minutes of Negotiations of PAL-2.⁴ These regulations go into force as soon as the proposed amendments to the law on banks and banking are adopted by the Verkhovna Rada. A special working group in the NBU continues to work with Bank Staff on further revisions of NBU regulations to make them fully compliant with all Basil Core Requirements, and toward gradual introduction of risk-based supervision. The National Bank has been regularly providing the World Bank with the status report on banks' compliance⁵ with prudential ratios reflecting the five, core Basil principles in focus of PAL-2, and has applied respective sanctions to non-compliant banks within the competence and authority of the NBU.
- (ii) This condition has been met. Following the April 18, 2003 letter of the Chamber of Auditors of Ukraine announcing the requirement to auditors to use the International Standards of Auditing (ISA) in their work, NBU has (i) jointly with the Chamber of Auditors agreed on the procedures for the registration of bank auditors; (ii) established the Auditing Committee under the auspices of NBU with participation of the representatives of NBU (Banking supervision and accounting departments) and auditors (Chamber of Auditors and certified auditors from the reputable Ukrainian audit firms); (iii) issued the revised requirements for annual external audit of banks' financial statements; and (iv) issued the Procedures for certification of bank auditors by the above mentioned Auditing Committee. All the banks were required to produce annual external audit reports according to ISA for year end 2003 and further on. According to the established NBU procedures, banks are required to submit to NBU the draft auditing contract and the documents confirming audit firm's compliance with the NBU requirements. NBU has a right to suspend or cancel the license of an individual auditor, instruct a bank to appoint a new auditor or require from a bank to arrange a new audit of financial statements should NBU find the previous audit report non-compliant with NBU

³ This refers specifically to rows 1 and 2 of part 2 of Annex 10. All points of Part 1 of Annex 10 were completed as prior actions for the Board presentation of PAL-2.

⁴ This refers specifically to rows 3 through 8 of part 2 of Annex 10.

⁵ This refers specifically to row 8 of part 2 of Annex 10.

requirements. During 2003-2004, NBU has certified or extended certificates for more than 60 individual auditors and suspended or temporarily deactivated licenses for 6 auditors. In addition, NBU prepared and submitted to Parliament revisions to the Law on Banks and Banking and Law on Auditing that envision strengthening of NBU powers in the area of bank auditing as was agreed during the PAL 2 negotiations.

- (iii) This condition has been met. Since July 2003, the Savings Bank has been operating under requirements established through a Memorandum of Understanding (MoU) co-signed by the National Bank of Ukraine, the Ministry of Finance of Ukraine and the Head of the Supervisory Board of State Saving Bank. While operating under restrictions of the MoU, Savings Bank was obliged to undergo diagnostics of its IT systems, its lending portfolio and its internal risk controls. In addition, it was required to develop a business plan acceptable to the signatories of the memorandum and develop a strategic plan for its restructuring. Savings Bank has successfully carried out its obligations and responsibilities under the MOU, although the signatories have not officially approved the Savings Bank's response to the MOU. The Savings Bank has adhered to the restrictions: in July 2004 it presented a three-year business plan satisfactory to the World Bank, and the diagnostics have been completed. Under the restrictions the Savings Bank had a financially successful year in 2004, reaching 98 percent of its required NBU provisions for non-performing assets. It has also achieved its required level of regulatory capital with the exception of NBU single borrower and insider exposure. Under the proposed Development Policy Loan for Ukraine, a Memorandum of Development will be put in place which outlines an operational and strategic solution for Saving Bank.
- (iv) This condition has been met. The Law on State budget for 2004 and 2005 has provided UAH 6.74 and 7.87 million respectively to finance the activities of the State Commission for Regulation of Financial Services Markets. This funding exceeds the amount provided to the Commission during its first year of operations, i.e. 2003. Although this level of funding is believed to be insufficient to cover the institutional development costs of the regulator (first of all in such areas as IT/MIS investment, training and adequate remuneration of staff), it is expected that the Government will undertake necessary steps to establish more conducive environment for enhancing the performance of the regulatory agencies, including increased institutional independence, strengthened enforcement powers, larger funding and more adequate remuneration and personnel development system.

Loan Agreement, Schedule 3, Paragraph 4. The Borrower continues to make progress towards its accession to the World Trade Organization, by: (i) the adoption, by its Cabinet of Ministers, of eleven (11) technical procedures based on the New Approach; (ii) the adoption, by its Cabinet of Ministers, of one thousand five hundred (1500) technical standards; and (iii) the development of a legal framework in correspondence with the requirements of TRIPS.

- (i) This condition has been met. Sixteen out of twenty-five technical procedures based on the EU "New Approach"⁶ were approved by official orders of the State Standards Committee and registered by the Ministry of Justice. Previously, the authority to issue these technical procedures was limited to the Cabinet of Ministers. However, on December 26, 2003, by Resolution of the Cabinet of Ministers of Ukraine No. 2022, this authority was

⁶ "New Approach" refers to the regulatory strategy laid down in the Resolution of 1985 of the Council of the European Union regarding the new approach to technical harmonization and standardization

delegated to the State Standards Committee. This clears the way for rapid preparation and adoption of the remaining eight procedures.

(ii) This condition has been met. As of February 21, 2005, 2,241 technical standards were harmonized with international and European standards and adopted by the State Standards Committee of Ukraine.

(iii) This condition has been met as the Verkhovna Rada has adopted relevant laws in area of intellectual property rights to bring Ukrainian legislation in minimum compliance with WTO TRIPS Agreement. On May 22, 2003, the Vekhovna Rada passed the Law "On Amendments to Some Legislative Acts of Ukraine on Legal Protection of Intellectual Property" No. 850-IV that entered into force on June 25, 2003. Also, Ukraine adopted a number of additional laws that create better framework for intellectual property owned by companies in WTO member countries. These include the law on distribution of audiovisual works and phonogram samples (dated August 21, 2003) and a law on amendments to some laws on intellectual property (pertaining to copyright and related rights) of 3 July 2002 No. 1296. This law has entered into force on June 25, 2003. Finally, the new customs code, which contains provisions to enforce intellectual property rights at the border, came into force on January 1, 2004.

Property Rights

Loan Agreement, Schedule 3, Paragraph 5. The Borrower has transformed the ownership and organizational structure in the agriculture sector through the enactment of a law which forms the legal basis for establishment of a unified system of registration for legal rights to land and real estate within a single agency.

This condition has been met. The Law of Ukraine "On State Registration of Property Rights to Real Estate and Their Limitations" No. 1952-IV of July 1, 2004 came into force on August 3, 2004. This law establishes the legal basis for creation of a single registry for land and real estate within a single agency.

Loan Agreement, Schedule 3, Paragraph 6. The Borrower has achieved further progress in the transparent privatization of large energy enterprises, by: (i) engaging the financial advisor for the privatization of a group of remaining state-owned *Oblenergos* and the launching of the corresponding privatization tender; and (ii) continuing the progress towards the completion of an unqualified audit of the consolidated financial statements of Naftogaz for 2004 on the basis of the IFRS.

(i) This condition has not been met, and a waiver is requested (see paragraphs 20-21 of this document). As was mentioned above, that the Government has confirmed that it stays committed to further reforms in energy sector, including adoption of energy debt restructuring law and subsequent launching of the privatization tender.

(ii) This condition has been met. Naftogas has achieved considerable progress in completion of an unqualified audit of the consolidated financial statements. BDO Balance-Audit has audited consolidated financial statements for 2001-2003. The required steps to make it possible for 2004 to be the first unqualified audit year for Naftogaz were taken, as agreed with the Bank. In particular, an inventory was conducted with the participation of auditors at the beginning and end of 2004. Also, a stock taking of the 100 percent proven oil and gas reserves was conducted by the international appraisal company Miller & Lents. This was required in order for the "fair market value" of Naftogas fixed assets to be assessed. This assessment was completed by Ernst & Young. Also, as required by

IFRS, the audited consolidated financial statements of Naftogas were made public (they are available on the company web-site). Moving forward, Ernst and Young has been selected to conduct an IFRS based audit of the consolidated financial statements of Naftogas for 2004-2008. Additionally, an agreement is being concluded with the international appraiser Miller & Lents on making an assessment of the oil and gas reserves for 2005.

Public Sector Accountability

Loan Agreement, Schedule 3, Paragraph 7. The Borrower has improved the use of public resources through the implementation of the CFAA Action Plan, by: (i) adopting, through its Cabinet of Ministers and, thereafter, publishing a white paper on internal financial control; (ii) establishing an external oversight body for the State Tax Administration; and (iii) satisfactorily implementing KAZNA in all Oblast treasury offices for the state budget, including for twelve (12) which shall also handle the local budgets.

- (i) This condition has been met. A *Concept for the Development of the System of Internal Financial Audit and Control to EU standards* has been developed by the Government with support of the World Bank. The text of this concept has been agreed with Bank Staff, and adopted by Cabinet of Ministers on May 18, 2005.
- (ii) This condition has been met. In compliance with Resolution of the Cabinet of Ministers No. 697 of May 26, 2004, an external Oversight Panel was established to effect supervision over STA activity. The Oversight Panel reviewed progress under the State Tax Administration Modernization Project during a visit to Ukraine in April 2005.
- (iii) This condition has been met. KAZNA system (an automated treasury system established by the Borrower's State Treasury) has been extended to cover expenditures of all oblast treasury departments for the state budget, as well as of all local budgets.

Loan Agreement, Schedule 3, Paragraph 8. The Borrower shall have introduced a more effective tax and revenue system through the reduction, since January 1, 2002, of no less than fifty-five percent (55%) of sector/industry specific tax exemptions and privileges, as measured by the resultant increase in the tax base.

This condition has been met. Recent Government efforts aimed at revision of the system of privileged taxation allowed to substantially reduce existing tax expenditures. According to the data provided by the Government, tax exemptions and privileges have been reduced over 2002-2004 by 80.3%.