

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

Report No.: PIDC106421

Project Name	Support to Ukrtransgaz PIU
Region	EUROPE AND CENTRAL ASIA
Country	Ukraine
Lending Instrument	IPF
Project ID	P163065
Borrower Name	Ministry of Economic Development and Trade
Implementing Agency	PJSC Ukrtransgaz
Environment Category	C - Not Required
Date PID Prepared	11-Jan-2017
Estimated Date of Approval	01-Feb-2017
Initiation Note Review Decision	The review did authorize the preparation to continue

I. Introduction and Context

Country Context

After a sharp contraction in economic activity during the first three quarters of 2015, initial signs of stabilization are emerging. Real GDP contracted by 9.9 percent in 2015 overall. The 2014 conflict led to a widespread disruption of supply and distribution chains and undermined confidence, while the drop in global commodity prices has led to a serious deterioration in Ukraine's terms of trade. Considerable fiscal and external adjustment in response to the shocks have further compressed domestic demand. Although the external economic environment remains difficult, the conflict in the east has de-escalated since September 2015, and macroeconomic and structural reforms have begun to restore confidence. As a result, real GDP contracted more modestly by 1.4 percent year-on-year in the fourth quarter of 2015, compared to 7.2 percent in the third quarter and 16 percent in the first half of the year. Industrial production declined by a more modest 5 percent in the fourth quarter of 2015 and rebounded to 7.6 percent in February 2016. Inflation remained high at 43.3 percent year-on-year in December 2015, due to the currency depreciation and utility tariff hikes, but abated from a peak of 61 percent in April.

Prospects for economic recovery remain uncertain and depend on how the conflict in the east unfolds and whether reforms on multiple fronts can be advanced in an uncertain political environment. If the conflict does not escalate further and progress is made on reforms, a gradual economic recovery is expected, with a growth of 1 percent in 2016 and 2 percent in 2017. The real depreciation, coupled with efforts to tap the European Union (EU) market, is expected to support exports and the tradable sectors. Furthermore, improved expenditure efficiency should create enough fiscal space to unlock public investment. Continued banking sector reforms should also permit a gradual resumption of lending. In the medium term, growth could pick up to 3-4 percent. The outlook is subject to serious risks, including an escalation of the conflict, the further deterioration in the external environment, and difficulty in advancing reforms in the face of political

instability. The current political uncertainty could seriously derail Ukraine's reforms and economic recovery.

The fiscal outlook remains challenging and has been shaped further by a cut in the social security contribution rate. The fiscal framework actually projects an increase in the fiscal deficit to 3 percent of GDP in 2016 (because of lower National Bank of Ukraine profit transfers). Meeting this deficit target will prove challenging, particularly in light of the payroll tax rate cut from 40 to 22 percent in 2016. The authorities anticipate that cutting tax rates would shrink the informal economy and improve compliance. However, estimates suggest that short-term revenue losses could amount to 3 percent of GDP, which would require challenging compensatory measures to broaden the tax base, strengthen tax administration, and rationalize current expenditures (including pensions and the large public sector footprint). If these challenging measures are successful, the fiscal deficit is projected to narrow further to 2 percent of GDP by 2018.

Ukraine will need to advance reforms on multiple fronts to achieve a sustainable recovery and shared prosperity going forward. First, in light of the difficult external environment and persisting vulnerabilities, safeguarding macroeconomic stability will be critical. This will require reforms to continue fiscal consolidation and strengthen the financial sector, while maintaining a flexible exchange rate. Second, Ukraine will need to improve productivity and create jobs by investing in infrastructure, improving the business climate, and taking advantage of trade opportunities. Third, Ukraine will need to provide smarter and more effective services to the population to ensure that the benefits of recovery are broadly shared. Intensifying anti-corruption and governance reforms to reduce the influence of vested interests will prove important across the board.

Sectoral and Institutional Context

The Government of Ukraine has launched an ambitious program to reform the gas sector and restructure and modernize the gas network infrastructure in Ukraine. In 2009 the Government of Ukraine, the European Commission (EC), and the International Financial Institutions (IFIs), including the World Bank (WB), the European Bank for Reconstruction and Development (EBRD), and the European Investment Bank (EIB), signed a Joint Declaration on the Modernization of Ukraine's Gas Transit System. Also, on September 24 2010, Ukraine signed a Protocol on Ukraine's Accession to the Treaty Establishing the Energy Community, which was ratified by the Verkhovna Rada of Ukraine on December 15 2010.

Consistent with its obligations assumed under *acquis communautaire*, Ukraine adopted the Law on the Natural Gas Market in April 2015 and the Government adopted the Gas Sector Reform Implementation Plan in March 2015. Consistent with the commitments assumed as part of the Law and the Implementation Plan, the Government adopted a package of secondary legislation (e.g. network codes, new tariff setting methodologies, Public Service Obligation, etc.), implemented gas and district heating subsidy reforms and adopted the unbundling plan for transmission (and storage) operations. Despite the progress made to date, substantial unfinished reform agenda remains in the gas sector, which is essential for eventual transparent, competitive and efficient functioning of the gas market.

To facilitate Government's reform efforts in the gas sector in the framework of membership of the Energy Community and building on the successful implementation experience of the first EC-WB Gas Facility, the second EC-WB Trust Fund was established.

The proposed grant will be extended from the EC-WB Second Trust Fund and will ensure continued support for the implementation of IFI-funded projects in 2016-18 to the PIU of Ukrtransgaz (UTG), a wholly owned subsidiary of Naftogaz. Specifically, the grant will support the ►(Reconstruction, Capital Repairs, and Technical Reequipping of the Main Gas Pipeline Urengoy-Pomary- Ughgorod►(project that is financed by the EBRD and the EIB.

Relationship to CAS/CPS/CPF

The proposed grant is consistent with the Country Partnership Strategy (CPS) for Ukraine (FY12-16). Specifically, it will support Pillar 1 of the CPS, improving public services and public finance, by improving the governance in the gas sector through modernization projects in the gas transit system.

II. Project Development Objective(s)

Proposed Development Objective(s)

The development objective of the proposed grant is to strengthen the capacity of Ukrtransgaz►(Project Implementing Unit.

Key Results

Progress made under the project will be monitored through the following outcome indicators:

PDO level results indicators:

- a. UTG PIU capacity is strengthened

Intermediate results indicators:

- b. Project implementation support consultant is on board
- c. Satisfactory audit of the grant is completed.

III. Preliminary Description

Concept Description

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:	1.047619	Total Bank Financing:	0
Financing Gap:	0		
Financing Source			Amount
European Commission Development Fund - TF			1.047619

VI. Contact point**World Bank**

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