

EBRD Country Strategy Comments

March 14, 2011

National Ecological Centre of Ukraine / CEE Bankwatch Network comments on the draft EBRD strategy for Ukraine

For more information

Olena Miskun
National Coordinator
miskun@bankwatch.org

Vladlena Martsynkevych
Central Asia Program Officer
vladlena@bankwatch.org

CEE Bankwatch Network's mission is to prevent environmentally and socially harmful impacts of international development finance, and to promote alternative solutions and public participation.

www.bankwatch.org

We welcome the opportunity to comment on the Draft Country Strategy for Ukraine. We consider the translation of the Country Strategy draft as a very important and valuable step to enhance wider public participation in the commenting process.

There are some strategic directions in the Strategy that we support (e.g. intentions to help to solve the solid waste problem in a sustainable way, gender-related objectives, etc.). Please, find attached our comments on the issues we would like to see EBRD change or improve its approach to.

Tax havens

There is a wide-spread practice recently that the bank provides financing to borrowers, whose owners are established or controlled by an entity established in an offshore jurisdiction. Even though the general business environment in Ukraine is not the most favorable compared with the other countries of the bank's operations and "*foreign investment in Ukraine has largely been made in off-shore holding companies where shareholder rights can more clearly be enforced by other courts and arbitral tribunals under foreign law*" (p.16), the EBRD, being a public bank, should not loan money to offshore companies facilitating private tax avoidance. This results eventually in the Ukrainian state ending up with debts and other fiscal liabilities while business does not build up the country's fiscal capacity.

The rough estimations in the table below reveal that there is a long list of EBRD clients and projects in Ukraine which use tax havens and similar secrecy jurisdictions. Only in 2010 the EBRD lending to the private clients registered in secret jurisdictions reached 78%, and even one of those not involving an offshore jurisdiction is still taking place under a special tax regime that will result in low tax income for the government.

Table 1. The EBRD lending to private clients registered in secret jurisdictions, in USD, 2010

project	project summary document	secret jurisdiction	tax haven	non tax haven
Laona	http://www.ebrd.com/english/pages/project/psd/2010/41511.shtml and http://www.ebrd.com/english/pages/project/psd/2010/42030.shtml	Cyprus	70	
Ukrplastic	http://www.ebrd.com/english/pages/project/psd/2010/41393.shtml	(n/d)		29,8
Mriya	http://www.ebrd.com/english/pages/project/psd/2010/41511.shtml and http://www.ebrd.com/english/pages/project/psd/2010/42030.shtml	Cyprus	50	
Astarta	http://www.ebrd.com/english/pages/project/psd/2010/40963.shtml	The Netherlands	14	
Nibulon	http://www.ebrd.com/english/pages/project/psd/2010/41658.shtml	Mykolayiv special tax zone		50
MHP	http://www.ebrd.com/english/pages/project/psd/2010/41132.shtml	Luxembourg	50	
UAFL	http://www.ebrd.com/english/pages/project/psd/2010/41181.shtml	Cyprus	20	
Energomash-spetsstal	http://www.ebrd.com/english/pages/project/psd/2010/40263.shtml	Cyprus	79	
		total	283	79,8
			78%	22%

“...when offshore jurisdictions are used, the EBRD makes use of internationally agreed processes and best practices designed to prevent misuse and to promote transparency and information exchange on tax matters”.¹

Thus we would like to propose to the Bank:
 1) **to state in its country strategy for Ukraine its position on the use of offshore companies in its projects and how it will seek to avoid this;** 2) **to explain in the Project Summary Documents the reason for the use of the offshore jurisdiction, what tax impact this is likely to have on the government, and what steps have been taken to assess alternatives to using offshore jurisdictions.**

¹ Offshore jurisdictions in EBRD projects, approved by the Board of Directors on 20 July 2010

We welcome the EBRD's policy on Offshore Jurisdictions in EBRD projects as a first step to regulate the issue; however we are unclear about what difference it will make to the EBRD's operations in practice. We believe there is a necessity from the EBRD's side to focus on promoting a progressive tax system, help strengthen the tax administration and fight against tax flight and the use of tax havens by companies operating in Ukraine.

Strategic Direction and Operational Priorities

The Bank's Priorities for the Strategy Period

We welcome the eagerness of the Bank to promote energy efficiency across all sectors as we consider Ukraine to have significant potential for improvement in that area. We also welcome the initiative to strengthen the energy and food security of Ukraine. We believe that Bank's willingness to promote reform of the wholesale electricity market and the tariff reform is of great importance for the energy market of Ukraine.

However there are several concerns connected with these issues (see also below).

"Although a primary focus will be on development of the private sector, the Bank would support key projects in energy and infrastructure under sovereign guarantees, conditional upon reforms." (p.21)

We believe that **every large project in energy and infrastructure** (especially under sovereign guarantees) should be subject to public scrutiny and should not be politically driven, but **must favour environmentally and socially sustainable development**. As in many countries of the region Ukraine has poor quality national sectoral strategies and projects, many of which are not compatible with sustainable development, and therefore the EBRD needs to take particular care to examine carefully the rationale for each project and the possible alternatives.

Sectoral Challenges and Bank Objectives

Among other things the Bank claims that it will *"support diversification of the sources of energy, improving energy security and energy efficiency"* (p. 22). We believe that **"promotion of generation of the renewable energy" should be mentioned here separately.**

In the power sector

- *"Modernisation of the transmission network, including its integration with the neighboring markets and providing electricity to energy-deficient regions of Ukraine."* (p. 23)

The modernization of the transmission network foresees in particular the construction of high-voltage transmission lines such Second Backbone UHV Corridor and 330 kV Novoodeska-Artsyz. We believe that **construction and putting into operation of these lines will lead to the preservation and further development of the existing old and dirty electricity supply system in Ukraine** (with the main energy sources being coal and nuclear) instead of promoting the shift toward renewable energy sources and an increased role for energy efficiency, where Ukraine has huge potential. It will also enable the Ukrainian government to offer this "unsustainable" electricity to EU countries while all the externalities (nuclear risks, air pollution, etc.) are put as a burden on Ukrainian society.

In order to provide electricity to energy-deficient regions, **priority should be given to low-voltage local grid (below 110kV) modernization and the development of technical solutions to integrate modern art renewable energy sources into the outdated design of the grid in the regions.**

The **commitment of the EBRD to invest money into the transmission lines also contradicts the Bank's Energy Operations Policy**. On one hand the Bank does not support construction of new nuclear capacities and is putting a lot of effort into the construction of new confinement structures for the Chernobyl NPP and on the other hand **it loans money for the construction of infrastructure for the export of the electricity generated at NPPs and for the extension of the lifetime of old NPPs** (see below).

"Development of renewable energy generation capacities, including under the Ukraine Sustainable Energy Lending Facility (USELF) and for

rehabilitation of existing hydro power plants’ (p. 23).

The promotion of renewable energy generation capacities is of great importance for Ukraine, but there is doubt about the efficiency of the USELF program in Ukraine. The size of the loans is comparatively big (EUR 1–15 million), and taking into account that this programme is aimed first of all at promoting renewable energy sources among agricultural producers, it is **doubtful that small and medium sized farms can afford it**. It is only achievable for big corporations, but the question is whether they need public money for it or could rather obtain it from another source at reasonable rates?

In the natural resource sector

Support to greater local sourcing of oil and gas, reducing dependency on imports – where possible with the implementation of enhanced oil/gas recovery combined with CO2 sequestration (p. 23).

The technology of enhanced oil/gas recovery can be very damaging to drinking water sources and the environment generally if not properly controlled. It is not very common in Ukraine and there is no procedure to control it properly. Moreover the Ukrainian translation of the Draft Country Strategy omits the term “enhanced oil/gas recovery” and uses the neutral “advanced methods of oil/gas extraction” that prevents correct understanding of the sentence.

Moreover, the recent mass media reports² that the EBRD is ready to invest nearly EUR 500 million in projects for oil and gas in Ukraine annually are very worrying. According to the Managing Director in charge of the energy and natural resources Riccardo Puliti, the Bank will invest one third in shareholder capital, and two thirds would be available as long-term loans as the EBRD is interested “in cooperation with drilling and shipping companies in Ukraine”³.

We strongly believe that **international financial institutions should not invest money into fossil**

fuel extraction, and especially in Ukraine, because as it is indicated in the very beginning that energy efficiency is to be the main focus of EBRD efforts in Ukraine for the next strategy period. Thus, **we would recommend removing this point from the Country Strategy**.

“Support of mining projects leading to greater transparency, improvement of health and safety standards or energy efficiency. The Bank will consider developing an integrated approach in the area of mine safety, including policy dialogue in this area, once the authorities focus on this subject following effective creation of the new Ministry of Energy and Coal” (p. 23).

The World Bank has already tried to implement the coal mine support project in Ukraine. According to the assessment of the project made by the WB “the project sustainability is assessed as unlikely”⁴.

We believe that EBRD should consider giving support to closing of the mines, restructuring of the mining industry and the development of alternative production in the mining regions: mine closure and rehabilitation, recultivation, post-closure toxic waste management, social programmes, such as retraining of miners, opening new economic opportunities for new jobs. As well EBRD should pay particular attention to gender issues, caused by increased economic stress on miners’ families, increased unemployment in post-mining communities.

In manufacturing and services

“Supporting viable companies in the old energy intensive industries such as steel and metals for energy efficiency and environmental improvements” (p. 25).

We consider this to be a very dubious moment; because the experience with ArcelorMittal Kriviy Rih (AMKR) has shown that the objectives of the loan (i.e. energy efficiency and environmental improvements) were hardly achieved if at all. The EBRD has confirmed this point of view in the Draft of Country strategy for Ukraine in the section “Key

² <http://www.unian.net/ukr/news/news-423936.html>

³ <http://www.nrcu.gov.ua/index.php?id=148&listid=140801>

⁴ http://www-wds.worldbank.org/external/default/main?pagePK=64193027&piPK=64187937&theSitePK=523679&menuPK=64187510&searchMenuPK=64187283&siteName=WDS&entityID=000094946_0107240402535

lessons learned from previous strategy period”. So we believe that the Bank is not able to control and enforce the implementation of environmental improvements and should not give more money to ArcelorMittal Kriviy Rih. Being the part of the largest **international steel corporation the AMKR should not benefit the public money** for “corporate restructuring and market expansion”. For other steel plants, **energy efficiency projects may be possible, but should be prepared much more thoroughly** than the AMKR project, with a clearer assessment of what is and is not possible to achieve.

In nuclear safety

“Following the successful completion of the EBRD/Euratom K2R4 programme, financing nuclear safety upgrades to bring the other 13 units to the same internationally accepted safety levels, in line with the EBRD’s Energy Policy” (p. 23).

The new Energy Policy of EBRD states that: *“while the Bank will not consider providing financing to new reactors, it may provide financing to an operating facility in relation to nuclear safety improvements”*. From this point of view the financing of nuclear safety upgrades envisaged for Ukraine seems to be in line with the EBRD Energy Policy, but the National Ecological Centre of Ukraine considers the nuclear safety upgrades to be a form of covert support for the nuclear industry in Ukraine. This is because **the list of “safety upgrade measures” coincide considerably with the measures needed to prolong the lifetime of the old nuclear reactors** and de facto give them new life. This is not a secret: the administration of Rivne Nuclear Power Plant openly admits that “safety upgrades” mean “extension” on its official web-site⁵. Such renewed old reactors pose much more danger than new ones, because of inevitable changes in materials and obsolescence. Thus, **we would ask the EBRD to remove this statement from the strategy** and instead to include the following:

“The EBRD should assist Ukraine with preparing and financing a programme to decommission nuclear

reactors as their designed lifetime comes to an end in the upcoming years, with the last reactor to be decommissioned in 2019”.

In agribusiness

We welcome the initiative of the Bank to increase access to financing by small farmers, as we consider the development of the potential of small and medium farms as a secure base for the food security of the country.

The road sector EBRD focuses (p.28)

“Exploring viable opportunities for engaging private sector in the rehabilitation and maintenance of infrastructure through competitive PPPs and output based contracting. “

The intention to use the PPPs in road construction and operation should be thoroughly weighed for every project and the proper financial analysis needs to take place. Judging from the results in other countries it seems that PPPs are most often used to avoid on-balance sheet debt, not because they offer better value for money, and we are extremely sceptical that any substantial risk is transferred during the operation stage. Therefore **we recommend removing PPPs from this sentence**.

“In aviation, supporting upgrades of air navigation systems, and promoting liberalisation of the aviation market along the “open skies” policy. “

This point should be removed as we consider support to aviation and airport rehabilitations not to be the proper sector for IFIs financing. This is because aviation is an already heavily subsidised industry worldwide, with no tax on kerosene and no VAT on air tickets. It also does little to benefit ordinary people, being mainly the preserve of business travelers and more well-off tourists.

Privatization

“The Bank will assist Ukraine in the development of its knowledge intensive industries and its better use of its human and scientific potential, as well as support the government’s privatisation programme of remaining state enterprises.” (p. 7, 24)

Non-transparent privatization processes have become a worrying and wide-spread practice in Ukraine.

⁵ <http://www.rnpp.rv.ua/dodatkovirozdili/novini/novini/browse/2/backPid/25/article/876/> and <http://www.rnpp.rv.ua/virobnictvo/modernizacija/>

The first example of this is the sale of Luganskteplovoy (May 2010), in which a potential participant to the contest was inexplicably excluded, with the subsequent abolition of the privatization results in the court. A second example is the sale of Azot, Severodonetsk in November without any competition (details of the sale were announced three weeks after the sale, although the tender announcement must be formally published by the State Property Fund not later than 60 days before the date of sale), and the price was 30% below the nominal value of shares. Third, in the planned sale of Ukrainian International Airlines there are suspicions that the buyer was known beforehand, and probably for this reason, the State Property Fund adopted a new statute for the company with provisions that made it impossible to conduct an open and transparent tender⁶. In this case even the EBRD's involvement – selling its shares at the very moment did not help to bring the process to an acceptably transparent level. The EBRD possessed only 10% stocks and participated in the company's capital for 10 years and intentionally sold its stakes at the moment⁷. The next privatization of Ukrtelecom already appears to be problematic, with only one bidder – LLC ASU (ACY) – a subsidiary of Austrian EPIC.

Thus, we would like to see the Bank's objective formulation changed as follows:

“The Bank will assist Ukraine in the development of its knowledge intensive industries and its better use of its human and scientific potential, as well as support the government's privatisation programme of state enterprises, ensuring the transparency of the process and its value for money for the public sector.”

Financial Intermediaries

We would like to draw attention to the financing through Financial Intermediaries, which made up the largest share among all sectors in 2010 – EUR 1.103 billion of the EBRD's Portfolio in Ukraine as of 31st December 2010.

⁶ <http://glavkom.ua/articles/2401.html>

⁷ <http://www.ukrainians.ca/hot/29701-ebrd-wishes-to-sell-its-stake-in-ua.html>

According to the draft strategy: *“The lending instruments would focus on MSMEs, financing energy efficiency improvements and trade facilitation, with the use of appropriate technical assistance.” (p.29)*

As stated elsewhere in our communications with the EBRD, we believe that in principle financial intermediation can be a useful tool for reaching MSMEs, provided it is clear that the financing benefits socially and environmentally beneficial activities. However so far the general public has no insight into who the final beneficiaries are of these operations or what development impacts have been attained. It would be possible and desirable to show which sectors and which sizes of business have benefited from sub-projects and what the average size of financing has been, as well as publishing in advance any planned sub-loans that would have been categorized as environmental category A or B had they been direct lending projects by the EBRD.

Efforts need to be made to support forms of intermediaries such as co-operative banks and credit unions, and to **ensure that EBRD standards are rolled out across banking operations**. This is in order to avoid situations where EBRD financing is used for less environmentally and socially dubious projects but the intermediary may use its other financing to support projects that the EBRD standards would not allow.

Environmental and Social Impact

Public transport

The EBRD financed a *“Significant number of urban transport projects was associated with rehabilitation and modernisation of public transport in such cities as Kyiv, Odessa, and Lviv. The latter will remain one of EBRD's priorities due to its sustainability potential and reduction of GHG emissions from congested traffic of private vehicles in major cities.”*

It is very promising that the Bank sees itself involved in promoting public transport in the cities of Ukraine. We consider this to be highly important.

However, in the area of the public transport we would like to mention several concerns related to Kyiv public transport. In recent media reports there were mentions of the buses and trolleybuses purchased by the Kyiv Administration – 185 Minsk trolleybuses and 185 “Bohdan”⁸ buses – with the EBRD's financing. However, it

⁸ <http://mignews.com.ua/ru/articles/65128.html>

was not clear whether there was a procurement notice and proper tender procedure. Also worrying is the fact that last year in November Kyivpastrans also announced the intention to purchase 77 trolleybuses from LAZ (Lviv)⁹ having 1 only company presented during the procurement process. This was a simplified procedure because there was a necessity to finalize it till the end of the year and there was a recommendation from the National Agency on the preparation for the final part of the Euro 2012.

As an example of possible corruption in an untransparent public transport purchasing scheme, Dnipropetrovsk Electrotransport purchased 48 used trams (23 and 32 years old) from Dresden¹⁰ that do not correspond to the requirements for electricity consumption and safety standards from Dnipropetrovsk Electrotransport's tender and 5 times overpriced¹¹ – for UAH 17 million loan from PrivatBank with an 18% rate with municipal guarantees. The public prosecutor in Dnipropetrovsk region has been asked to investigate the case for possible corruption.

Transparent procurement and tendering issues should be among the priorities for the EBRD public transport projects and should be monitored more carefully than is currently the case to ensure value for money for the public sector.

Municipal Infrastructure projects

The “EBRD will continue to support improvements in **municipal environmental infrastructure and services** through projects involving district heating, rehabilitation of water, wastewater and waste management facilities that have associated social and economic benefits through cost saving energy efficiency measures and better public health.” (p. 32)

There is no doubt that improvements in the utility sectors are needed. However, for example, in case of the Dnipropetrovsk Municipal Water and Waste-Water Project¹² the project works have started only in the recent years even though the loan was provided in 2004, there have been many delays. Now what is being observed by local people is that the

prices for services are rising, but the services do not improve.

Another example is Zaporizhzhya vodokanal that received financing¹³ with state guarantees in 1999 for the Zaporizhzhya – Water Utility Development & Investment Program that was planned to be accomplished in four years but it has taken more than ten and is still not completed. The report of the Audit Chamber of Ukraine identified several problems with the project¹⁴ that led to delays and unsatisfactory project fulfillment: problems with contractors, illegal or ineffective use of finances; financial miscalculations and lack of responsibility of all the state agencies responsible for the project; the state company Vodokanal inflated the planned price of the construction by UAH 17.7 million; and the technical equipment for the emergency pipe repair costing EUR 0.4 million and bought with EBRD's money practically cannot be used. The water service charges significantly increased making it problematic for the local people to pay for, and thus the Bank's loan repayment has to be put on the state budget.

Nothing is known about the energy efficiency implications for the projects mentioned above and the Bank's statement that “high energy efficiency benefits were demonstrated by Zaporizhzhya and Dnipropetrovsk municipal projects” (p.32) remains unproved.

Ukraine received the possibility to access funding from the operation of the €90 million multi-donor Eastern Europe Energy Efficiency and Environment Partnership (ESP) Fund managed by the EBRD¹⁵ recently. This fund will focus on district heating, other energy efficiency projects as well as on waste water or renewable energy. Thus we recommend the Bank to take into consideration the experience with the projects that are being implemented with water programmes.

Thus we would like to emphasize our recommendations concerning the Bank's planned focuses (p. 27) in these areas:

1. *“Continuing to support commercialization of municipal utilities and enterprises through projects with large demonstration effects.”*

We would recommend adding to the above “... **based on real on-the-ground improvements and better services provided,**” as we do not believe that commercialization is

⁹ <http://www.kommersant.ua/doc.html?DocID=1533934>

¹⁰ <http://gorod.dp.ua/news/60986>

¹¹ <http://gorod.dp.ua/news/60986>

¹² <http://www.ebrd.com/english/pages/project/psd/2004/32011.shtml>

¹³ <http://www.ebrd.com/english/pages/project/psd/1997/2857.shtml>

¹⁴ <http://www.ac-rada.gov.ua/control/main/uk/publish/article/16719271>

¹⁵ <http://www.ebrd.com/pages/news/press/2011/110224a.shtml>

a goal in itself.

2. *“Shaping key product offerings on improving district heating, water and wastewater, but also urban transport and solid waste management solutions.”*

For these aims to be realized, **tender and procurement transparency and close scrutiny of value for money for the public sector should be in place.** The Bank can foster and ensure this to happen – or if it cannot, it must send a clear signal to the authorities by openly refusing to participate in projects.

3. *“Supporting private sector involvement in the provision of municipal services in accordance with transparency and concession standards acceptable to the Bank.”*

We would like to emphasize the need for proper evaluation and analysis of whether private sector participation is the most appropriate route, taking into account the mixed experience of private sector participation in public services in Central European countries, where it was already introduced. In order to increase the effectiveness of public services in transition countries, the **EBRD should also consider public–public partnerships.**

Municipal Solid Waste

“One of the most serious Ukrainian environmental challenges is the problem of **household waste** disposal and fly-tipping and associated lack of waste segregation and utilization and land filling capacity. As per Ministry of Environmental Protection of Ukraine, only 6 per cent of rubbish is recycled in Ukraine compared to 30–40 per cent in Western Europe. There is a high potential for Bank’s future involvement in this area.”(p. 32)

We strongly support the Banks’ engagement in projects with sustainable municipal solid waste treatment. Collection, separation, and recycling services and plants are extremely needed in Ukraine in all the cities, as well as for solving the waste problem in smaller towns and villages. We also call on the EBRD to adopt an integrated approach and concentrate on preventing waste production in its other projects.

Gender Action Plan

We are very pleased to see the inclusion of the gender issue into the Country Strategy. However, we

feel that concrete commitments on measures to promote gender equality are still missing in the general language on gender considerations.

“As part of the implementation of the EBRD’s Gender Action Plan, the Bank will continue to support women’s entrepreneurship through Financial Institutions projects by increasing the access to finance for women-owned MSMEs and women entrepreneurs and address barriers that impede access to credit, particularly in rural areas.” (p. 32)

This aspect is very important. However, is no way for the public to check on the results.

“In other priority sectors, the Bank will focus on identifying and encouraging clients to adopt gender balanced approaches in their human resources policies and practices (e.g. work–life balance, flexible working hours, family friendly initiatives, etc).” (p. 32)

This statement goes in line with the recommendations raised in Bankwatch’s report on the labour and gender issues in the Ukrainian supermarket chain Furshet. We hope that the EBRD has learned valuable information from the study and will monitor the implementation of the EBRD’s policies and national labour legislation by all its clients.