EN 2016 NO 32

Special Report

EU assistance to Ukraine

EUROPEAN COURT OF AUDITORS

EUROPEAN COURT OF AUDITORS
12, rue Alcide De Gasperi
1615 Luxembourg
LUXEMBOURG

Tel. +352 4398-1
Enquiries: eca.europa.eu/en/Pages/ContactForm.aspx
Website: eca.europa.eu
Twitter: @EUAuditors

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(pursuant to Article 287(4), second subparagraph, TFEU)

Audit team

02

The ECA's special reports set out the results of its performance and compliance audits of specific budgetary areas or management topics. The ECA selects and designs these audit tasks to be of maximum impact by considering the risks to performance or compliance, the level of income or spending involved, forthcoming developments and political and public interest.

This performance audit was produced by Chamber III – headed by ECA Member Karel Pinxten - which specialises in external action, security and justice spending areas. The audit was led by ECA Member Szabolcs Fazakas, supported by Márton Baranyi, Attaché of his private office; Beatrix Lesiewicz, Principal Manager, and Francis Joret, Principal Manager ad interim; Christian Geoffroy, Head of Task; Alina Milasiute and Balazs Kaszap, Auditors.

From left to right: B. Kaszap, B. Lesiewicz, F. Joret, S. Fazakas, C. Geoffroy, A. Milasiute, M. Baranyi.

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Abbreviations and acronyms

AAP: Annual action programme

ACU: Accounting Chamber of Ukraine

CRIS: Common Relex Information System

CSO: Civil society organisation

CSP: Country strategy paper

DG: Directorate-general

EAMR: External assistance management report

EBRD: European Bank for Reconstruction and Development

EEAS: European External Action Service

EIB: European Investment Bank

ENI: European Neighbourhood Instrument

ENPI: European Neighbourhood and Partnership Instrument

EUAM: EU Advisory Mission for Civilian Security Sector Reform

FAC: Fight against corruption

GDP: Gross domestic product

GRECO: Group of States against Corruption

IMF: International Monetary Fund

IFI: International financial institution

MFA: Macro-financial assistance

NABU: National Anti-Corruption Bureau of Ukraine

NIP: National indicative programme

OECD: Organisation for Economic Cooperation and Development

PCA: Partnership and cooperation agreement

PEFA: Public expenditure and financial accountability

Abbreviations and acronyms

PIFC: Public internal financial control

PFM: Public finance management

SBC: State building contract

SGUA: Support Group for Ukraine

SIGMA: Support for improvement in governance and management

TACIS: Technical assistance to the Commonwealth of Independent States and Georgia

VAT: Value added tax

Executive summary

I

Ukraine is one of the European Union's largest and politically most important direct neighbours. Institutional and political instability, governance issues, and economic and financial difficulties predominate in the country. The conflict in eastern Ukraine has greatly exacerbated the economic and financial challenges. However, Ukraine has launched many significant reforms since the Maidan events of 2014.

II

EU–Ukraine cooperation is part of the European Neighbourhood Policy and its eastern dimension, the Eastern Partnership. After lengthy negotiations, the Association Agreement signed in 2014 will replace in its entirety the 1994 Partnership and Cooperation Agreement once the former enters into force. The European Neighbourhood and Partnership Instrument, which was replaced by the European Neighbourhood Instrument in 2014, provided most of the bilateral assistance. During the audited period (2007-2015), EU financial assistance consisted of 1.6 billion euros in grants, half of which was in the form of budget support, and of 3.4 billion euros in macro-financial loans.

III

Over most of the period audited, the unstable political, legislative and administrative context limited the effectiveness of EU assistance. EU–Ukraine cooperation advanced in the wake of the 2014 Maidan events, but the challenges faced by Ukraine still heavily affect the reform process and the risks posed by the oligarchs remain high. The EU response to the Ukraine crisis of 2014 (the 2014-2020 package of 11.2 billion euros), although prompt, was an emergency solution. The EU was able to allocate and disburse large amounts of money rapidly and without a predefined strategy.

IV

The audit objective was to assess whether Commission and EEAS (European External Action Service) assistance was well prepared, appropriate and effective in supporting the transformation of Ukraine into a well governed state in the area of public finance management (PFM) and the fight against corruption (FAC),as well as in the gas sector during the 2007-2015 period. The audit scope included all EU budget support and macro-financial assistance programmes initiated since 2007, as well as the financial instruments from the Commission's package launched in 2014.

V

Overall, EU assistance to Ukraine has been partially effective in supporting the transformation of Ukraine into a well governed state in the areas mentioned in paragraph IV.

VI

EU assistance to Ukraine was partially effective in producing tangible and sustainable results in PFM and FAC. PFM occupied a modest place in EU–Ukraine dialogue for most of the 2007-2013 period. Until 2014, the Ukrainian government's limited commitment to the reform process was reflected in incomplete and delayed outcomes. FAC has been reinforced by the 2011 Visa Liberalisation Action Plan and further accelerated by improved post-Maidan cooperation. Despite the new impetus for reform since 2014, the results achieved so far remain fragile. In the case of FAC policy, the results of effective implementation remain to be seen. Certain shortcomings in the way conditions were stipulated or in the method their fulfilment was assessed affected the design of the budget support programmes and macro-financial assistance. Most budget support programmes in Ukraine were designed to disburse a significant proportion of the allocated amount at the beginning of the programme once general conditions had been fulfilled. To address the critical situation of Ukraine in 2014, the Commission focused on rapid disbursement of assistance. Monitoring of the implementation of EU assistance was largely effective. Suspensions of budget support payments advanced PFM priorities in 2011-2013.

VII

EU assistance to Ukraine was partially effective in improving governance in the gas sector and in securing gas supplies via Ukraine. EU–Ukraine dialogue on gas covered a broad range of issues but was affected by Ukraine's wavering commitment and by diverging views among EU stakeholders as regards the security of EU gas supplies via Ukraine. The design of the reviewed EU assistance to improve governance in the gas sector and the security of gas supplies via Ukraine included certain conditions that were vague and difficult to assess. Sometimes, monitoring of the implementation of EU assistance lacked high-quality data and EU–Ukraine joint reporting did not provide a sufficiently detailed explanation of the difficulties experienced in the gas sector. Until 2014, EU assistance had limited impact on the functioning of the Ukrainian gas sector and produced mixed results as regards the security of the EU's gas supplies via Ukraine. However, important milestones have since been achieved, notably the adoption of a gas law in April 2015 compliant with the EU third energy package.

VIII

This report sets out five recommendations for improving EU assistance to Ukraine.

Introduction

Geographical and political background

01
Ukraine covers an area of 603 000 km^2 and was home to 44.3 million inhabitants in 2014. The country gained full independence in 1991 with the collapse of the Soviet Union. Since the 2004 enlargement of the European Union to central and eastern Europe, Ukraine has been one of the Union's largest and politically most important direct neighbours.

02
Political and institutional instability predominates in the country. Since 2004, three major events have occurred: the Orange Revolution of 2004, the presidential election of 2010 (which was held largely democratically and peacefully) and the Maidan Revolution[1] of 2014.

03
Since the beginning of 2014, Ukraine's territorial integrity has been seriously threatened. At the time of the audit, the Ukrainian army was in conflict with Russian-backed separatists in certain areas of the Donetsk and Luhansk regions, and Russian forces had annexed the Crimean Peninsula[2].

Economic and financial situation

04
Ukraine has a track record of poor economic performance since it gained independence in 1991. Positive economic growth rates in the early 2000s were severely impacted by the 2008 global crisis and have struggled to recover ever since. Ukraine's state finances have deteriorated over the years mainly because of mismanagement of public funds. In addition, the revenue side of the state's budget is negatively affected by a significant shadow economy[3]. Despite reform efforts, Ukraine is still perceived as the most corrupt country in Europe[4]. Vested interests influence public policymaking. Oligarchic clans, which have developed considerably since the country became independent, continue to exert a dominant influence on Ukraine's economy, politics and media.

1 Other terms are also used, e.g. Euromaidan or the (Euro) Maidan events, protests, demonstration or uprising, and the Revolution of Dignity.

2 Russia claims that Crimea is part of the Russian Federation on the basis of a referendum held on 16 March 2014, which was condemned as illegal by the Ukrainian Government, the European Union, the United States and the United Nations General Assembly.

3 Ukraine's shadow economy, the largest in Europe, is estimated to account for around 44 % of GDP. See Igor Vinnychuk and Serhii Ziukov, 'Shadow Economy in Ukraine: Modelling and Analysis', Yurii Fedkovych Chernivtsi National University, 2013.

4 Ukraine was rated 130 out of 168 by Transparency International in 2015 (and 142 out of 175 in 2014) (See http://www.transparency.org/cpi2015/#results-table).

05

The conflict in eastern Ukraine has greatly exacerbated the economic and financial situation, absorbing the country's limited financial resources and effectively destroying the most important industrial area of the country. In early 2014, the Ukrainian government identified their foreign aid needs to be at around 35 billion US dollars over the period 2014-2015. The deficit of the state-owned gas company Naftogaz has been an increasing drain on the state's finances, rising from 1.9 % of GDP in 2013 to 5.7 % of GDP in 2014, when it was higher than the overall government deficit of 4.6 %[5].

EU–Ukraine cooperation framework

06

EU–Ukraine cooperation is part of the European Neighbourhood Policy and its eastern dimension, the Eastern Partnership. Cooperation progressed mainly with the signing of the Partnership and Cooperation Agreement (PCA) in 1994, the EU–Ukraine Action Plan in 2005 and the Association Agenda in 2009[6].

07

In March 2007, the EU and Ukraine opened negotiations on a 'New Enhanced Agreement' (since September 2008 called Association Agreement) to replace the PCA; negotiations were concluded in December 2011 and the Agreement was initialled. As part of the preparations for signing the Agreement at the 16th EU–Ukraine Summit in February 2013, Ukraine confirmed its determination to achieve tangible progress in three areas: remedying electoral shortcomings, addressing the issue of selective justice and preventing its recurrence, and implementing the reforms set out in the Association Agenda. On 21 November 2013, Ukraine decided to suspend preparations for signing the Association Agreement. This sudden reversal sparked the massive Maidan demonstration in support of political association and economic integration with the EU. In the wake of the Maidan events, the EU and Ukraine signed the political provisions of the Association Agreement on 21 March 2014 and the remaining provisions on 27 June 2014[7]. The Agreement provides for the enhancement of EU–Ukraine relations in all areas of cooperation and also constitutes a reform agenda, based on a comprehensive programme to bring Ukrainian legislation into line with EU norms.

5 IMF Country Report No 15/69, 'Ukraine: Request for Extended Arrangement Under the Extended Fund Facility and Cancellation of Stand-By Arrangement Staff Report', International Monetary Fund, March 2015.

6 The 2009 Association Agenda was updated in 2011, 2013 and 2015.

7 By mid-April 2016, the Association Agreement had been ratified by the Verkhovna Rada (Parliament of Ukraine), the European Parliament had given its consent to the conclusion of the agreement, and 27 Member States had also ratified it (the Netherlands has not yet taken the final decision on the ratification following the negative outcome of a national referendum). Parts of the Association Agreement have been applied on a provisional basis.

EU financial assistance

08

Financial assistance, in the form of grants to help Ukraine implement the Action Plan, was provided mainly by means of the European Neighbourhood and Partnership Instrument (ENPI)[8], which was replaced by the European Neighbourhood Instrument (ENI) in 2014[9]. ENPI bilateral assistance to Ukraine was programmed via the 2007-2013 Country Strategy Paper (CSP) and two national indicative programmes (2007-2010 and 2011-2013 NIPs). No new CSP or NIP has been announced since then due to the difficult situation. Most ENPI–ENI assistance (65 %) was granted using a sector budget support approach. Ukraine also received EU grants through the Instrument for Nuclear Safety Cooperation and the Instrument contributing to Stability and Peace.

09

In addition to grants, the EU has provided Ukraine with macro-financial assistance (MFA), i.e. loans which are released in several instalments ('tranches') upon fulfilment of conditions related to the macro-economic situation and sectoral reforms. ***Table 1*** shows the distribution of EU financial assistance to Ukraine in grants and loans during the 2007-2015 period.

8 Regulation (EC) No 1638/2006 of the European Parliament and of the Council of 24 October 2006 laying down general provisions establishing a European Neighbourhood and Partnership Instrument (OJ L 310, 9.11.2006, p. 1).

9 Regulation (EU) No 232/2014 of the European Parliament and of the Council of 11 March 2014 establishing a European Neighbourhood Instrument (OJ L 77, 15.3.2014, p. 27).

Table 1 EU bilateral assistance to Ukraine, 2007-2015, allocation by instrument (million euro)

	Total allocations[1]	
	Amount	Share
Overall EU assistance to Ukraine (including MFA)	**5 019**	**100 %**
Total grants	**1 609**	**32 %**
ENPI/ENI [2]	1 330	27 %
of which		
Budget support[3, 4]	794	16 %
Other ENPI/ENI grants	536	11 %
Instrument contributing to Stability and Peace	54	1 %
Instrument for Nuclear Safety Cooperation	225	4 %
Total macro-financial assistance (MFA) loans	**3 410**	**68 %**
MFA I	610	12 %
MFA II	1 000	20 %
MFA III	1 800	36 %

1 Data until 30 November 2015.
2 European Neighbourhood and Partnership Instrument/European Neighbourhood Instrument.
3 Includes State Building Contract.
4 Excludes 29 million euros that were allocated to complementary actions (technical assistance).

Source: CRIS (Common Relex Information System) and DG Economic and Financial Affairs website (MFA).

10
In March 2014, the Commission announced an indicative Ukraine support package of 11.2 billion euros, including up to 8 billion euros of EIB (European Investment Bank) and EBRD (European Bank for Reconstruction and Development) loans for the 2014-2020 period to support the reform process (see paragraphs 17 to 18).

Specific context of EU assistance to Ukraine

The unstable political, economic and administrative situation hampered EU–Ukraine cooperation

Negotiations for the Association Agreement reinforced EU–Ukraine dialogue

11
During the audited period, EU–Ukraine dialogue took place within a broadly structured framework which was shaped by negotiations and the subsequent provisional application of the Association Agreement. Current EU–Ukraine cooperation efforts are guided by the Association Agreement signed in 2014 and the 2015 version of the Association Agenda. High-level cooperation was discussed at the annual EU–Ukraine summits and the EU–Ukraine Cooperation/Association Council meetings. To assist the Cooperation/Association Council, the EU–Ukraine Cooperation/Association Committee was set up, along with seven subcommittees in charge of monitoring progress on the Action Plan and the Association Agenda[10]. Visits by Commissioners and senior officials also contributed to the dialogue process. Public finance management, the fight against corruption and energy were formally included within the remit of the dialogue process.

Political and administrative instability slowed the pace of EU–Ukraine dialogue and the progress of reforms

12
Political instability in Ukraine strongly affected the EU–Ukraine cooperation and the implementation of EU assistance. Between 2004 and 2014, Ukraine experienced three significant political changes (see paragraph 2), leading to major shifts in the political orientation of the country, especially towards its European aspirations. These changes had a significant impact on legislation, such as backtracking on accepted legislation and counter-revisions, and on the stability of public administration, especially at mid- and senior-management levels.

13
Over the audited period, Ukrainian public administration underwent several attempts at restructuring (e.g. in 2010-2011). Until 2014, the restructuring process was hampered by a lack of political will to comply with EU governance standards. It was carried out in an ineffective manner and affected the implementation of EU programmes on the ground. We found that at the time of the audit, there was a strong political commitment to public administration reform. However, the rotation of mid and senior management jeopardised the reforms supported by EU assistance and the sustainability of results, while low salaries created a potential incentive to corruption.

10 At the time of the audit, the new cooperation entities required by the Association Agenda were in the process of being established.

14
We found that in the wake of Maidan, cooperation advanced in a number of areas that had been stagnating throughout the 2007-2013 period (e.g. public procurement reform and reorganisation in the energy sector). However, the economic and geopolitical challenges faced by Ukraine heavily affect government priorities and the activities of the public services.

Since 2010, the Commission has increasingly emphasised the risks posed by the oligarchic system

15
We found that since 2010, the Commission has been more outspoken about the risks posed by the oligarchic system in Ukraine, such as dysfunctional public administration, top-down corruption and public finances used to advance private goals[11]. The Commission assessed the risk of conflicts of interest at all levels of Ukrainian administration as very high, and sought to moderate the risk by means of formal dialogue and budget support suspensions. Hope was also placed in the implementation of the strategies for public finance management reform (2013) and anti-corruption (2014)[12]. Regarding the specific issue of privatisation, EU budget support and macro-financial assistance programmes did not include conditions to ensure that future privatisations are open and fair. However, the Commission supported the IMF's (International Monetary Fund) privatisation goals by referring to IMF programme implementation in the MFA conditionalities.

16
Legal initiatives since the beginning of 2015 have sought to break the oligarchs' hold over Ukraine's politics and economy. However, the level of risk remains high (see ***Box 1***) and concrete results are still below expectations (see paragraph 63).

11 EAMRs 2010, 2011, 2012 (not publicly available).

12 European Commission Risk Management Framework for Ukraine, Risk Register 2012-2014 (not publicly available).

Box 1

Activation of the Ukrainian authorities' campaign against the oligarchy

In 2015, the Ukrainian government initiated a campaign in line with EU requirements to loosen the oligarchs' grip on the country's economic and political system. Under this initiative, various investigations and prosecutions were launched and the assets of some oligarchs were placed under scrutiny, in particular in the energy sector. However, these measures were sporadic and controversial, and faced strong opposition from past and current oligarchs. Some of the oligarchs took their own initiatives for proposing reforms for Ukraine[13].

13 For example, the Agency for the Modernisation of Ukraine — a non-governmental organisation headquartered in Vienna and financed by a Ukrainian oligarch active in the energy sector — was launched in March 2015 to present an own, separate Ukraine modernisation action plan and establish a restoration fund. The Agency hired figures who had formerly been prominent at EU and Member State level. As the Agency's activities largely duplicate those of the Ukrainian government and the EU, there is a risk of confusion with the EU's official assistance to Ukraine.

The EU response to the Ukrainian crisis in 2014, although prompt, was an emergency solution

The Commission's March 2014 financing package consisted mainly of potential loans

17

On 5 March 2014, the Commission announced an indicative package of 11.2 billion euros for 2014-2020 (see ***Table 2***) to help stabilise the economic and financial situation in Ukraine, assist with the transition process, encourage political and economic reforms, and support inclusive development[14]. Given the urgency of the situation, at the time of the political announcement (5 March 2014) the Commission produced this package without a comprehensive analysis of the way the assistance had been calculated or of the arrangements for cooperating with other donors, and the financial risks for the EU were neither appropriately considered nor documented. Analysis and documentation followed later, accompanying the Commission proposals for legislative acts.

14 See http://europa.eu/rapid/press-release_IP-14-219_en.htm and, for further details, http://europa.eu/rapid/press-release_MEMO-14-159_en.htm.

Table 2

EU support for Ukraine — Indicative Package for 2014-2020, as announced on 5 March 2014

Source of financing	Indicative amounts (*million euro*)
I. EUROPEAN COMMISSION (2014-2020)	
I.1 Overall development assistance (grants)	**1 565**
Bilateral allocation (mainly European Neighbourhood Instrument):	
- Annual Action Programme (AAP) for 2014	140-200
- AAPs (average) - for 2015-2020	780
- Umbrella programme ('more for more') for 2015-2020	240-300
Neighbourhood Investment Facility	200-250
Instrument contributing to Stability and Peace (IcSP)	20
Common Foreign and Security Policy (CFSP)	15
I.2 Macro-financial assistance (loans)[1]	**1 610**
II INTERNATIONAL FINANCIAL INSTITUTIONS	
EIB	up to 3 000
EBRD	5 000
GRAND TOTAL	**11 175**

1 In addition, a new MFA loan (MFA III) of 1.8 billion euros was granted in 2015.

Source: European Commission.

18
In itself, the March 2014 financial package consisted mostly (71.5 %) of potential loans to Ukraine from the EIB and the EBRD. There is no certainty that EIB and EBRD allocations will be fully disbursed[15]. The package increased the value of grants to around 220 million euros per year until 2020, up from around 140 million euros per year during 2007-2013. However, the grants under the umbrella programme (based on the 'more for more' principle) are not guaranteed as they are conditional upon proven progress in deepening democracy and respecting human rights. On the other hand, disbursements under MFA (2.21 billion euros out of 3.41 billion euros) already exceed the indicative amount of the package announced in March 2014. We found that the macro-financial assistance instrument managed by the Commission was the most effective means of rapidly disbursing the support promised to Ukraine for dealing with its difficult financial situation (see paragraph 43).

The Commission used special measures to address the crisis in Ukraine rapidly

19
EU policy towards Ukraine is supported by a number of strategic documents setting principal objectives and priorities and aiming to make EU policy consistent and effective. However, such strategic documents were not designed to guide policymaking in a crisis situation like the one that began in Ukraine in November 2013. The Commission was obliged to cope with radical changes quickly and without a predefined strategy.

20
Due to the crisis, the multi-annual programming procedure for Ukraine was put on hold. The Commission could not use its standard Single Support Framework outlining priority sectors on a multi-annual basis to allocate assistance for 2014 and 2015. As provided for in the regulation[16] the Commission committed assistance in the form of annual special measures.

15 Since 2014, the EIB and EBRD have managed to contract around 940 and 870 million euros of respective project loans (indicative amounts by end of July 2015).

16 Articles 2.5 and 2.1 of Regulation (EU) No 236/2014 of the European Parliament and of the Council of 11 March 2014 laying down common rules and procedures for the implementation of the Union's instruments for financing external action (OJ L 77, 15.3.2014, p. 95).

The EU set up ad hoc structures to manage its greater involvement in Ukraine

21

In parallel to the significant increase in EU assistance to Ukraine in 2014, the EU established new entities calling upon additional expertise to advise Ukraine on the reform process. The two most notable initiatives are the Support Group for Ukraine (SGUA) from the Commission and the EU Advisory Mission for Civilian Security Sector Reform (EUAM)[17]. Both the SGUA and the EUAM significantly enhance EU–Ukraine cooperation. They provide expertise in targeted sectors already being assisted by the EU Delegation. We found that there was therefore a risk of overlap with the EU Delegation's activities and of confusion for the Ukrainian authorities, in particular in the fight against corruption, an area which lies within the remit of all three parties. In 2015, the Commission took steps to address this risk[18].

22

To secure the use of increased EU funding, in June 2014 the Commission also envisaged creating a joint, independent body with the Ukrainian authorities to investigate fraud and corruption[19]. By the end of 2015, this joint body had not yet been created.

Donors stepped up their coordination in response to the Ukrainian government's weakness in this area

The Ukrainian government was weak at donor coordination

23

Donor coordination was poorly managed by the Ukrainian authorities. There was little communication among ministries, no interlocutor on the Ukrainian side and an unclear attribution of responsibilities. The 2006 and 2011 Public Expenditure and Financial Accountability (PEFA) assessments (see paragraph 46) also critically assessed flows of financial information on external assistance between the Ukrainian government and donors. Although the Ukrainian government made an attempt to centralise donor coordination in 2008-2009, clear mandates were not allocated and political support shifted quickly, meaning that the initiative failed.

17 EUAM is a non-executive, unarmed, common security and defence policy (CSDP) mission supporting, advising and mentoring Ukrainian political and institutional stakeholders on Civilian Security Sector Reform (CSSR) at a strategic level.

18 E.g. to limit overlaps, the temporary solution found was that the EUAM would be working on the set-up of the anti-corruption bureau while the SGUA would be dealing with anti-corruption reforms at the level of the ministry of Justice.

19 Memo of 25 June 2014 on the European Commission's support for Ukraine http://europa.eu/rapid/press-release_MEMO-14-279_en.htm.

24
Since 2014, the Ministry of Economic Development and Trade has undertaken a number of donor coordination actions, but their outcomes and sustainability at this time remain uncertain[20]. The process of drafting the law on international technical assistance, started in 2012, has been suspended since 2014.

Since 2014, the donor community has improved its internal coordination

25
The increasing donor involvement in Ukraine raises additional challenges in terms of coordination within the donor community, and strains an already weak absorption capacity on the ground. Since 2014 the Commission has met frequently with other major donors. Together they produced and are maintaining a map of assistance to Ukraine. We noticed that the donor map revealed parallel activities, such as EU and USAID (United States Agency for International Development) projects in the area of justice. While the Commission does not participate in the EBRD Multi-Donor Fund, mechanisms are in place to help the EBRD coordinate its project and programme decisions with the relevant Commission departments.

20 At the time of the audit, donor coordination mandates had not yet been assigned and a clear donor coordination policy within the government of Ukraine had not yet emerged. A high-level meeting to coordinate international support for Ukraine (with representatives from multiple donor countries, the EU, other key international institutions and donor organisations) was held on 8 July 2014 in Brussels. A donors' and investors' conference was convened in autumn 2014 to examine the implementation of Ukraine's Economic Recovery and Growth Agenda for 2014-2016. It was replaced by an International Conference on Support for Ukraine for the donor/business community and civil society in April 2015.

Audit scope and approach

26

For the 2007-2015 period, we examined whether Commission[21] and EEAS assistance, referred to hereafter as EU assistance[22], was effective in supporting the transformation of Ukraine into a well-governed state. We focused on the area of public finance management (PFM) and the fight against corruption (FAC), and on the gas sector and energy efficiency. These areas, are particularly important to Ukraine's reform process and have received significant EU assistance. The aim was to enhance governance by promoting the use of international standards and best practices[23].

27

The audit scope included all ENPI and ENI EU budget support and macro-financial assistance programmes initiated since 2007, as well as the instruments from the Commission's financial package launched in 2014 in response to the crisis situation in Ukraine. The programmes examined are listed in the ***Annex***.

28

We carried out the audit work between June 2014 and December 2015. The audit centred on:

— the effectiveness of EU assistance to Ukraine in improving public finance management and the fight against corruption; and

— the effectiveness of EU assistance to Ukraine in improving governance in the gas sector and the security of gas supplies to the EU.

29

The audit was based on interviews and exchanges of correspondence with the Commission, the EEAS and the EU Delegation to Ukraine, Ukrainian authorities and agencies, civil society organisations (CSOs), EU Member States[24], international financial institutions, and the International Energy Agency, as well as documentary review, including policy and strategy documents and other relevant reports from think tanks and CSOs. In addition, the audit included a 1-week visit to Kyiv in March 2015.

21 Mainly DGs responsible for Neighbourhood and Enlargement Negotiations, for Economic and Financial Affairs and for Energy.

22 Up until the end of 2010 the European Commission was responsible for developing the ENP approach and then programming and implementing the assistance and the overall ENP cooperation framework. Following the establishment of the EEAS in December 2010, the EEAS became responsible for policy development and the overall cooperation framework and the EEAS and Commission shared responsibilities for programming assistance. Implementation of assistance remains the responsibility of the Commission.

23 Examples are: For PFM to implement Intosai standards and methods, harmonise with international standards for public internal control, and work towards approximation with the EU *Aquis* in public procurement. For FAC ratify and implement the UN Convention against Corruption and the Council of Europe Criminal Law Convention on Corruption.

24 France, Italy, Hungary, Slovenia and Sweden.

Part I — Effectiveness of EU assistance to Ukraine in improving public finance management and the fight against corruption

30

We examined whether EU–Ukraine dialogue was effective in addressing issues of public finance management and the fight against corruption, whether EU assistance was designed and monitored in such a way as to contribute effectively to the improvement of PFM and the FAC, and whether it produced tangible and sustainable results in these areas. The main documentary evidence used for our findings, and discussed with the auditees, were internal sources such as Commission internal management reports — monitoring, annual progress and compliance reports, and external sources such as PEFA, SIGMA, OECD and CSO reports.

EU–Ukraine dialogue on public finance management has significantly improved since 2013, and that on fight against corruption since 2011

EU–Ukraine dialogue on public finance management: a fragmented approach and no credible PFM reform strategy until 2013

31

PFM and FAC were formally included within the remit of the dialogue structures (see paragraph 11). However, PFM occupied only a modest place in EU–Ukraine dialogue for most of the audited period. The key EU–Ukraine dialogue documents focused on a limited number of PFM components[25]. Both PFM and FAC barely featured in the 2007-2013 Country Strategy Paper and in the two national indicative programmes (2007-2010 and 2011-2013 NIPs).

32

The 2010 Evaluation of the European Commission's Cooperation with Ukraine[26] was highly critical of the way the PFM issue was addressed in Ukraine, noting that there was no framework for in-depth policy dialogue with the government of Ukraine on PFM issues. No specific subcommittee was dedicated to PFM as a whole. PFM components (e.g. audit, financial control and public procurement) were discussed in various relevant subcommittees. Neither the Joint Monitoring Groups created to assess progress on implementing the sector budget support programmes nor the Subcommittee on Economic and Social Affairs, Finance and Statistics, which met only once a year and covered a very wide range of topics, were considered by the evaluation an appropriate or sufficient structure for this purpose[27].

25 The select PFM components were public procurement, taxation, and — to a much lesser degree — public internal financial control (PIFC), external audit and budget planning.

26 'Evaluation of the European Commission's Cooperation with Ukraine', Evaluation for the European Commission carried out by ADE — Analysis for Economic Decisions, December 2010.

27 Ibidem, p. 87.

33

One long-standing issue was the lack of a credible PFM reform strategy. In 2007, the government of Ukraine adopted a PFM strategy that had been prepared with the assistance of the World Bank. The EU proposed a budget support programme in PFM during the audited period, in 2007 and 2010. Both proposals were cancelled because a 50 million US dollar World Bank project launched in January 2008 was expected to cover PFM issues in sufficient depth. However, the World Bank's Public Finance Modernisation Project did not achieve its objectives[28]. From 2010, several key studies and evaluations pointed out the weaknesses of the Ukrainian PFM strategy[29].

34

In reaction to these criticisms, from 2011 the EU became much more explicit in its demand for PFM reform[30]. In 2012, the Ministry of Finance set up a working group on PFM in order to draft a reform strategy allowing for the resumption of budget support which had been suspended in 2011 as a consequence of slow progress on PFM, specifically in public procurement. The Commission — particularly through the EU Delegation in Kyiv — extensively helped the Ministry of Finance to develop an acceptable PFM reform strategy and action plan before the 2013 Vilnius Summit.

EU–Ukraine dialogue on the fight against corruption: a slow start, limited progress despite EU efforts over most of the audited period and a new impetus in the wake of Maidan events

35

FAC was mentioned in the action plans related to the EU–Ukraine Partnership and Cooperation Agreement of 1994 and was on the agenda for dialogue with Ukraine. After the 2004 Orange revolution, Ukraine made attempts to boost FAC by creating a new framework based on analyses and recommendations by international organisations. The EU urged Ukraine to join the Council of Europe's Group of States against Corruption (GRECO) and implement its recommendations, and to ratify the UN's conventions against corruption. Ukraine became a member of GRECO in 2006 and ratified the UN conventions in 2009. Progress on implementing international recommendations was slow until 2010[31].

36

In December 2010, the newly elected Ukrainian parliament abolished the anti-corruption legislative package and other measures which had been adopted in 2009 but never implemented. In response, since 2011 the EU has included objectives dealing with anti-corruption legislation and anti-corruption bodies in the Visa Liberalisation Action Plan.

28 The final project appraisal from 2015 gives overall outcome rating of 'unsatisfactory': 'Outcome: Relevance of objectives is rated Substantial, given the government's agenda to reform public financial management. Relevance of design is rated Modest, as it is not clear that the project's planned activities addressed the transparency objective. Achievement of the objective to strengthen public financial management in terms of operational efficiency was Modest. Achievement of the objective to strengthen public financial management in terms of transparency was Negligible. Efficiency is rated Modest. These ratings are indicative of major shortcomings in the project's preparation and implementation, and therefore an Outcome rating of Unsatisfactory.' (See http://documents.worldbank.org/curated/en/2015/12/25709407/ukraine-public-finance-modernization-project).

29 The SIGMA review published in 2011 noted that the strategy was mainly geared towards the goals of the World Bank's PFMP while the coverage of other PFM areas was superficial. The scope of the strategy was also criticised in the Study on PFM issues in Selected Countries in the European Neighbourhood region and in the 2010 Evaluation of the European Commission's Cooperation with Ukraine.

30 Following the summit of 19 December 2011, Commissioner for Enlargement and European Neighbourhood provided the First Deputy Prime Minister of Ukraine with a non-paper with PFM requirements to advance forward in budget support. The requirements included a creation of the PFM working group, the establishment of the PFM reform strategy and the development of the PFM Action Plan.

37
In the wake of the Maidan revolution, the EU took further steps to reinforce its FAC recommendations. Following the signing of the Association Agreement in 2014, the 2015 EU–Ukraine Association Agenda listed more specific short-term priorities, in particular to implement the anti-corruption legal package adopted on 14 October 2014 and to set up and ensure the effectiveness of both the National Anti-Corruption Bureau and the National Agency for the Prevention of Corruption. Regarded as a key element in mitigating the risk of anti-corruption reforms being stalled, civil society organisations were more involved in the dialogue process.

The design of the assistance enabled rapid disbursements but did not always take sufficient account of the reforms to be achieved

Conditions on public finance management and the fight against corruption that were included in budget support programmes and macro-financial assistance had several shortcomings

38
PFM reform is part of the general conditions for budget support[32] that need to be deemed fulfilled before any disbursement. These general conditions are the only condition necessary for the fixed 'tranches'. A positive PFM assessment depends on satisfactory progress on implementing a PFM reform strategy[33]. However, financing agreements for budget support programmes in Ukraine were not always clear as to what steps, based on specific milestones or outputs, constituted the required level of 'satisfactory progress'[34].

39
In addition to the general PFM condition for disbursement of all tranches and to PFM and FAC projects, some programmes included specific PFM or FAC indicators for the disbursement of the variable tranches. The indicators accounted for a substantial portion (10-20 % overall) of the relevant variable tranches. The relatively modest fulfilment rate for those specific indicators reflected the limited added value of this approach in the PFM reform process (see paragraph 50).

31 See OECD Anti-corruption Network for Eastern Europe and Central Asia, Istanbul Anti-Corruption Action plan, 'Second Round of Monitoring, Ukraine, Monitoring Report', December 2010 (https://www.oecd.org/corruption/acn/istanbulactionplancountryreports.htm).

32 Sector budget support programmes are usually a mix of fixed and variable instalments (tranches). Fixed tranches are linked to the fulfilment of general conditions and variable tranches are additionally linked to progress against specific indicators. General conditions apply to the disbursement of all tranches and comprise national/sector policies and reforms ('public policies'), stable macro-economic framework, public financial management, and — since 2012 — transparency and oversight of the budget.

33 E.g. border management budget support programme includes a condition that only requires 'progressive improvement in developing MTFF'; Energy II budget support programme of 2012 also includes a very broad PFM condition — mentioning unspecified programme to improve PFM.

34 See also the Court's Special Report No 11/2010 'The Commission's management of general budget support in ACP, Latin American and Asian countries' (http://eca.europa.eu).

40

Under macro-financial assistance programmes, the financing agreements do not allow the Commission to disburse the instalments in proportion to the degree of compliance with the conditions stipulated in the programme. It therefore applies a margin of appreciation to the wording of the conditions and the extent to which they have been assessed as fulfilled. However, this margin proved to be broad in some cases (see ***Box 2***):

Box 2

Flexibility in setting and assessing the fulfilment of MFA conditions

- Some PFM conditions negotiated for the 2013 MFA I were worded in general terms, thus allowing considerable margin for assessing the extent of implementation[35] (this also applies to the energy-related MFA I conditions; see paragraph 70).
- Additionally, all MFA loans to Ukraine include conditions that merge several subconditions into one for the purpose of assessing progress; this may complicate the assessment process if only part of the overarching condition is fulfilled[36].
- In the case of macro-financial assistance conditions, the terms used to qualify the fulfilment stage varied from one programme to another[37] and there were no clear cut-off points for partial assessments.

35 Examples of very general wording in MFA I: 'continue to make progress in establishing a system of public procurement', 'appropriate increase in the number and quality of audits' and 'make significant progress towards strengthening the VAT administration system'.

36 MFA I 2nd tranche — conditions 1, 2, 4 (PFM), condition 11 (energy); MFA II condition 4 (FAC); MFA III 2nd tranche — conditions 5 (PFM), 6 (FAC), and 8 (state-owned enterprises); MFA III 3rd tranche — conditions 7 (FAC), 13 (energy), 18 (trade), 19 (justice). In total, there are 12 composite conditions, accounting for 17 % of all Ukraine MFA conditions.

37 Fulfilled (MFA I and II), currently fulfilled (MFA I), broadly fulfilled (MFA I and II), partly fulfilled — progress made (MFA II), not fulfilled but good progress (MFA II).

Sector budget support was generally frontloaded despite a relatively poor track record in structural reforms

41

Sector budget support programmes were generally designed to disburse a large share of the allocated amount at the very beginning of the programme. Budget support frontloading, i.e. the initial fixed tranche paid in full and generally without delay, ranged from 31 % to 49 % before 2012 (see ***Table 3***).

42

Although within the general limits suggested by the budget support guidelines[38], the frontloading of the sector budget support programmes designed over the 2007-2010 period contrasted with the weak track record of reform policy implementation in Ukraine[39] (see also ***Figures 1*** and ***2***) and the relatively poor fulfilment of the variable tranche conditions. The design of the two latest programmes (Energy II and Regional Development), which entails a smaller initial fixed tranche, takes greater account of the risk that high fixed tranches may lower the appeal of implementing the reforms upon which payment of subsequent variable smaller tranches is conditional.

38 For example, budget support guidelines suggest a sector budget support fixed-variable tranche mix of 60-40 %; with higher variable tranches for countries with greater risk and a poorer implementation record.

39 Based for example on annual progress reports, EAMR reports and analysis of the performance assessment reports prior to the payment of sector budget support.

Table 3

Ukraine: Sector budget support frontloading (initially allocated amounts)

Programmes[1]	Total	Fixed tranches	Variable tranches	Fixed tranches
	In million euro			in %
Energy Efficiency (2008)	63	31	32	49 %
Energy I (2007)	82	40	42	49 %
Environment (2009)	35	15	20	43 %
Border Management (2010)	60	25	35	42 %
Transport (2009)	65	27	38	42 %
Trade (2008)	39	12	27	31 %
Regional development (2013)	50	6.5	43,5	13 %
Energy II (2012)	45	5	40	11 %

1 The amounts include only the budget support component and exclude the complementary support component (24 million euros in total for Energy I, Trade, Energy Efficiency, and Border Management).

Source: European Commission.

In 2014 and 2015, the design of EU assistance focused on potentially rapid disbursement

43

To address Ukraine's critical balance of payments and fiscal position, the EU financial assistance allocated since 2014 mainly consisted of rapidly approved and disbursed general budget support grants (State Building Contract — SBC) and macro-financial assistance loans (see ***Table 4***). MFA loans (2.21 billion euros disbursed) now dominate EU disbursements to Ukraine, dwarfing all other forms of EU aid, including cumulative budget support. This surge in MFA loans to Ukraine is also unprecedented for DG Economic and Financial Affairs, considerably exceeding their overall cumulative MFA disbursements from 2002-2014.

44

The frontloading of the MFA II loan to Ukraine, together with less stringent conditions than for MFA I, was in response to the risk of financial and ultimately political collapse. Similarly, the Commission disbursed 250 million euros or 70 % of the State Building contract in June 2014, within a month of signing[40], leaving 105 million euros (30 % of the total) for the relatively condition-heavy variable tranche (8 conditions and 29 indicators).

Table 4

Ukraine: Rapid disbursement of MFA and SBC in 2014 and 2015 (at 31.12.2015)

Support	Programmes (year of signing)	Total	Disbursed in 2014	Disbursed in 2015	Outstanding
		In million euro			
Macrofinancial assistance loans	MFA I (2013)	610	360	250	0
	MFA II (2014)	1 000	1 000	NA	0
	MFA III (2015)	1 800	NA	600	1 200
	Total MFA	3 410	1 360	850	1 200
Budget support	State Building Contract (2014)	355	250	0	105
Grand total		3 765	1 610	850	1 305

Source: European Commission.

40 *Source:* http://europa.eu/rapid/press-release_IP-14-676_en.htm.

Monitoring of the implementation of EU assistance has improved

The EU and various international organisations regularly assessed the situation of public finance management and the fight against corruption in Ukraine

45

Throughout the audited period, various EU and international organisations/instruments assessed the PFM[41] and FAC[42] sectors in Ukraine. The PFM sector and FAC status were also well known because of the implemented projects and the annual EU delegation management reports (EAMRs). European Neighbourhood Policy Progress Reports were also instrumental in designing EU assistance to Ukraine, although they have explicitly addressed the budget transparency issue only since 2015.

The monitoring framework for budget support has improved, but there is no systematic approach for independent budget support evaluations

46

The 2006 and 2011 Public Expenditure and Financial Accountability reports were a prominent source of reference for the Commission's positive PFM sector assessments. This was despite Ukraine's mediocre PEFA scores[43] and some features of the PEFA itself: PEFA assessments are not frequent enough to monitor the use of EU funds and PEFA indicators do not entirely cover the PFM priorities targeted by EU policies. The budget support guidelines[44] still designate PEFA as the preferred high-level PFM assessment instrument, but since 2010 the Commission has also used its own PFM Annual Report to assess yearly progress.

47

Since 2012, the Commission has also strengthened its budget support monitoring framework by creating the inter-service Budget Support Steering Committee and establishing a risk management framework.

41 The main reference documents on PFM were: two DG Economic and Financial Affairs operational assessments (2009 and 2014); EU Delegation annual PFM reports since 2010; two PEFA assessments jointly by the World Bank and the EU (2006 and 2011, see paragraph 0); and the SIGMA (Support for Improvement in Governance and Management) assessment published in 2011.

42 The main references for the FAC were the progress reports on the Visa Liberalisation Action Plan since 2011, the 2013 United Nations Office on Drugs and Crime report, GRECO reports, Council of Europe and OECD (Organisation for Economic Cooperation and Development) reports, Transparency International surveys and the Istanbul anti-corruption action plan.

43 In both PEFA assessments, the ratio of strong (A and B) to average and weak (C and D) indicators was around 40 %-60 %, with the proportion of Ds increasing in the 2011 report. Fundamental issues were the extent of unreported government operations, the oversight of aggregate fiscal risk from other public sector entities, the effectiveness of payroll controls and external audit. *Source:* World Bank. 2012. Ukraine — Public financial management performance report. Washington, DC: World Bank. http://documents.worldbank.org/curated/en/2011/01/16461565/ukraine-public-financial-management-performance-report

44 Budget Support Guidelines for 2007 and 2012.

48

We found that EU budget support in Ukraine is not evaluated systematically. For each programme, the Commission can establish the evaluation framework in the financing agreement. The Commission planned mid-term evaluations only for three sector budget support programmes in Ukraine: Energy I, Energy Efficiency and Border Management. No final *ex post* evaluation was ever carried out, but the evaluation of overall budget support operations in Ukraine was finally completed in 2014[45].

The Commission's suspension of EU assistance payments advanced public finance management priorities

49

The outright suspension of budget support payments was effective as a 'last resort' attempt to advance EU priorities in the PFM sector. The Commission used it twice in 2011. In 2014 and 2015, postponing MFA disbursements also helped to ensure that certain conditions attached to the programme were implemented properly (see ***Box 3***).

Box 3

Examples of payments being withheld to advance reforms

- In February 2011, disbursements under all budget support programmes were suspended in response to backtracking on the 2010 internationally acceptable procurement law. The suspension was reversed in September 2011 only after a public procurement law deemed compatible with international good practices was passed by Ukraine's parliament in July 2011.
- In response to stagnating EU–Ukraine cooperation and the longstanding lack of a credible PFM reform strategy, all budget support payments requested in 2011 were suspended in December 2011. On 27 November 2013, following the official adoption of the acceptable PFM reform strategy and Action Plan, the delayed budget support payments (nine tranches of a total of 87.9 million euros) were disbursed.
- It proved difficult to discern sufficient progress on conditionality for the MFA tranches paid in 2014 and 2015. The Commission delayed disbursement of the final tranche of MFA I until April 2015. It also delayed payment of the second MFA II tranche until December 2014 when it was able to establish sufficient progress by the Ukrainian counterpart.

45 IBF International Consulting, 'Evaluation and Budget Support Operations in Ukraine, Final Evaluation Report', September 2014.

The results of EU assistance remain fragile

Limited progress on reform and reluctance by the Ukrainian authorities affected the fulfilment of specific PFM and FAC conditions and delayed budget support implementation

50
Over most of the period audited, incomplete fulfilment of general and specific PFM and FAC conditions in budget support programmes mainly reflected the Ukrainian authorities' reluctance to implement concrete governance reforms. The first instalments were delayed on several occasions largely because the general PFM conditions had not been fulfilled (see paragraph 49). The disbursement rate for the variable tranches subject to specific PFM and FAC conditions ranged from 67 % for the Energy I programme to only 25 % for the Energy Efficiency and Border Management programmes. The fact that, in the programmes with several variable tranches, the second tranche generally had a lower fulfilment rate than the first one also reflected the lack of momentum in the reform process.

51
The pace of reform is also slower because the Ukrainian authorities channel the sector budget support funds disbursed by the EU through an extra-budget fund. Budget support funds are considered as revenue in a Special Fund and are disbursed over a lengthy 11-step procedure. For the first instalment of Energy I, it took 2 years to complete the procedure. This was criticised both in the mid-term evaluation of the Energy I programme and in the 2014 evaluation of the budget support programmes in Ukraine. According to the latter evaluation, by mid-2014 only around half of the disbursed budget support funds had been transferred for budget execution.

The majority of public finance management conditions in macro-financial assistance were assessed as broadly fulfilled, despite shortcomings in implementation

52
In the PFM section of MFA I and II, the Commission assessed half of the conditions as broadly fulfilled and only one as non-fulfilled. However, for disbursement purposes, the Commission used its margin of appreciation and positively assessed several PFM conditions even though implementation on the ground was affected by shortcomings (see ***Box 4***).

Box 4

Examples of shortcomings in the fulfilment of PFM conditions for MFA loans

MFA I second instalment:

- Condition 2: Although the Anti-Monopoly Committee became operational, it faced budgetary uncertainty for 2015 and there is still a risk of significant constraints on resources.
- Condition 4: Even though a training strategy for internal control officials had been adopted for all levels of government, the strategy had weaknesses (insufficiently elaborated, poorly devised, no specific timeline, lack of information on funding, no quantitative criteria and weak links to PFM sector reform). Internal audit certification had not been introduced.

MFA II second instalment:

- Condition 1: Although a significant number of procurement bodies and contracting authorities did publish their procurement plans on time, the majority were insufficiently elaborated. In addition, the link between procurement needs and the state budget was questionable given the late adoption of the 2015 State Budget (29 December 2014).

The Ukrainian government achieved a number of legislative goals for public finance management, but many long-term issues remain

53

The Commission generally considers the 2013 PFM reform strategy and Action Plan to be key PFM achievements for the audit period[46]. The Ministry of Finance has shown a relatively high level of commitment to the strategy. However, the sustainability of the reforms achieved and the visibility and continued relevance of the strategy directly depend on continued political commitment by Ukraine. ***Figure 1*** gives an overview of developments in the main PFM areas over the audit period.

54

Despite incomplete fulfilment of the conditions attached to EU and other donor assistance, a number of legislative decisions related to PFM were adopted between 2010 and 2012. However, the government of Ukraine did not pay enough attention to their proper enforcement: the related national legislation was of poor quality, insufficient funding was allocated; and controversial and regressive legal amendments were enacted. Immediate implementation was therefore generally unsuccessful. Advancing PFM reforms in this period was all the more difficult because there was no structured PFM reform strategy until 2013 (see paragraph 34).

46 Based on interviews with Commission staff and annual progress reports.

Figure 1

PFM developments in Ukraine, 2010-2015

PFM areas	PFM developments in 2010-2013		PFM developments in 2014-2015
	Improvements	Challenges/shortcomings	
Public procurement	• 2010/2011 - New, relatively progressive procurement laws • 2010 - Anti-monopoly Committee established	• Controversial and regressive legal amendments, required heavy-handed EU interventions. • Anti-monopoly Committee lacked funds.	• New public procurement law, number of exceptions reduced, non-competitive awards declined. • Anti-monopoly Committee operational, but significant constraints and budgetary uncertainty.
Tax administration	• 2010 - New Tax Code	• New Tax Code considered by donor and business community to be of poor quality.	• New reform of tax system. • VAT arrears have declined but risk of increase remains. • Electronic VAT implemented in 2015.
Public internal financial control	• Draft law available in 2008 • 2011 - Legal basis for PIFC standards • 2012 - Code of ethics/ methodological recommendations • From 2012 - Internal audit units in ministries and other government organisations	• PIFC law implementation repeatedly postponed.	• PIFC provisions clarified further, but not entirely compliant with EU PIFC standards. • New strategy for training state officials responsible for internal control and audit.
Accounting Chamber of Ukraine		• 2010 – ACU remit significantly reduced by excluding revenues.	• ACU remit re-extended to revenues. • New ACU law extended ACU remit to state-owned enterprise transactions with the state. • Staff reductions from 550 to 386.
Budget transparency			• Missed deadlines and lack of public consultation for the 2015 state budget.
Budget code	• 2010 – New Budget code	• Considered to have a number of weaknesses.	• Budget code amended: focus on budget decentralisation. • Consolidation of three extra-budgetary social funds.

Source: European Court of Auditors.

55
Reforms were given new impetus in 2014 and 2015, principally by a series of additional legislative decisions, followed by visible improvements in the management of public procurement, revenue administration and state budget procedures. In the area of public procurement, for example, the number of exceptions and the share of procurement contracts awarded on a non-competitive basis started to decline in 2014. In cooperation with the IMF, the government of Ukraine developed and began to implement a strategy to reform revenue administration. Furthermore, initial steps were taken in 2015 towards results-based budgeting and medium-term planning.

56
Major progress in budget oversight was achieved with the adoption of a new law on the Accounting Chamber of Ukraine (ACU, the supreme audit institution of Ukraine), which entered into force on 9 August 2015. The ACU's mandate was extended in order to fulfil the conditions set by the EU, the World Bank and other donors. Paradoxically, the ACU law also requires a reduction in the organisation's resources[47].

57
Despite progress achieved since 2014, several long-term issues remain: the risk of backsliding (for example in public procurement exemptions and budgetary transparency), a lack of funds for the Anti-Monopoly Committee, the risk of rising VAT (value added tax) arrears, and weaknesses in the PIFC approach.

Significant steps to combat corruption were taken only after the Maidan revolution but further consolidation of the anti-corruption framework is still needed, as are tangible results

58
Figure 2 lists the EU's main actions over the audited period to help Ukraine set up its legal and institutional anti-corruption framework.

47 The ACU's resources were a key issue that the Commission discussed with the Ukrainian authorities in January 2015 ahead of the decision to disburse the third tranche of MFA I. The draft ACU law required the organisation's resources to be reduced by introducing a staff ceiling (a maximum of 250). This ceiling was raised substantially (when compared with the initial draft) to 386 in the final version of the ACU law, following intervention by the Commission when it reviewed the implementation of MFA conditionality.

Figure 2

Main anti-corruption developments in Ukraine, 2006-2015

	EU actions	Legislative decisions and institutional changes	Comments
2015 2014	• MFA II and III conditionality • State Building Contract • EU Advisory Mission for Civilian Security Sector Reform (EUAM) • Support Group for Ukraine (SGUA) assistance to Ministry of Justice • Ongoing Visa Liberalisation Action Plan	• Establishment of Specialised Anti-corruption Prosecutor's Office (November 2015). • Laws strengthening the legislative framework for asset recovery (November 2015). • Laws on prevention and counteraction of political corruption and the funding of political parties (October 2015). • Coordination body: the National Council on Anti-corruption Policy (October 2014). • Anti-corruption legal package (October 2014) establishing: (1) Anti-corruption Strategy 2014-2017, (2) National Anti-corruption Bureau of Ukraine (NABU) and (3) National Agency for Corruption Prevention. • Criminal Law on Corruption (June 2014).	• The government blocked the law on prevention of corruption for 9 months. • Outputs in line with FAC priorities of the 2015 Association Agenda. • Long-run impact will depend on genuine law enforcement.
2013 2012	• Ongoing Visa Liberalisation Action Plan	• Several legislative amendments, e.g. concerning offences related to corruption and the confiscation of gains of corruption.	• Some progress on aligning FAC with international standards.
2011	• Visa Liberalisation Action Plan • Budget support programme Public Administration Reform	• Anti-corruption Law passed in April 2011 (partially replacing the anti-corruption package revoked in December 2010). • Budget support programme for Public Administration Reform *not implemented* because the requisite Civil Service Law failed to meet basic EU principles.	• Anti-corruption Laws did not fully comply with international standards. • Budget support programme de-committed in 2013.
2010	• MFA I Conditionality • Project Support to Justice Sector Reforms (Component 5 Independence of the Judiciary and Component 6 Prevention and fight against corruption) • Border Management Budget support programme	• Anti-corruption Strategy 2014-2017. • Support for setting up the National Anti-corruption Bureau of Ukraine (NABU) since 2014. • Unsatisfactory results from Border Management programme *(no progress demonstrated as regards the level of corruption at the Ministry of Revenues and Duties).*	Implementation delays: • MFA I launched in 2014; • Project Support to Justice Sector Reforms launched in 2013.
2009-2006	• 2006 TACIS Project Against Corruption	Outputs related to: • creation of a strategic and institutional framework against corruption; • strengthening capacities for corruption prevention; • strengthening anti-corruption legislation.	• Low impact due to abolishment of existing anti-corruption package by the new Parliament in December 2010.

Source: European Court of Auditors.

59
The fight against corruption was on the agenda of the EU–Ukraine dialogue process (see paragraphs 35 to 37), but was rarely taken into account in assistance programmes before 2010. The overambitious[48] 2006 TACIS (Technical Assistance to the Commonwealth of Independent States and Georgia) Project against Corruption in Ukraine, launched in the wake of the Orange revolution, had minimal impact because in December 2010 political reasons led Ukraine's parliament to revoke the first anti-corruption package of laws adopted in 2009[49].

60
From 2011 onwards, the EU boosted legislative reforms by including benchmarks in the Action Plan on Visa Liberalisation offered to Ukraine in December 2010. The anti-corruption legislation adopted in April 2011 and subsequent legislative amendments passed in 2012 and 2013 were a positive development as they brought Ukraine's anti-corruption laws into line with recommendations made by the Commission and GRECO. However, although substantial progress was achieved in 2013, further improvements were necessary to complete the anti-corruption framework[50]. In particular, the Commission drew attention to the poor quality of Ukraine's legislative process and to the fact that the reforms lacked a comprehensive strategic approach[51]. The anti-corruption institutions in place until 2014, i.e. the National Anti-corruption Committee and the Government Agent on Anti-Corruption Policy, had been dysfunctional and were unable to carry out their mandate properly.

61
In 2014, the Ukrainian government began to cooperate closely with civil society on anti-corruption legislation. Important laws were passed in 2014 and 2015. Legislative and institutional progress continued in December 2015[52]. There was also progress when new institutions were established in 2014 and 2015, i.e. the Anti-corruption Bureau (NABU)[53], the specialised anti-corruption Prosecutor's Office in charge of overseeing NABU's investigations, the National Agency for the Prevention of Corruption and the National Council on Anti-corruption Policy.

62
By 2015, Commission and OECD regarded Ukraine's anti-corruption framework as closely aligned with international standards and EU benchmarks. At the same time, a number of additional results were yet to be achieved to make the framework effective, including[54]:

— allocation of proper budget resources to ensure that anti-corruption institutions function well and that the anti-corruption strategy and related action plan are implemented;

48 Based on monitoring reports.

49 OECD, 'Anti-corruption reforms in Ukraine', Monitoring of the Istanbul Anti-corruption Action Plan, March 2015, p. 17. The first anti-corruption package of laws consisted of (1) the Law on principles for preventing and counteracting corruption, (2) the Law on the liability of legal persons for corruption offences and (3) the Law on amendments to certain legislative acts of Ukraine regarding liability for corruption offences.

50 COM(2013) 809 final of 15 November 2013, p. 11, 'Third progress report on the implementation by Ukraine of the Action Plan on Visa Liberalisation'.

51 Ibidem, p. 14.

52 SWD(2015) 705 final f 18 December 2015, p. 6, 'Sixth progress report on the implementation by Ukraine of the Action Plan on Visa Liberalisation'.

53 NABU is an investigative agency dealing with corruption by senior public officials and corruption involving significant bribes even if no high-level public official was involved. NABU is formally a state law enforcement authority, and is not subject to government control.

54 See SWD(2015) 705 final and OECD, Monitoring of the Istanbul Anti-corruption Action Plan, progress updates, 7-9 October 2015.

— further improvements to the legal framework in order to ensure the full independence and integrity of the specialised anti-corruption Prosecutor's Office;

— improvement of legal provisions regarding the National Asset Recovery Office and the Asset Management Office;

— clarification and coordination of the specific anti-corruption tasks of institutions such as the Security Service of Ukraine and the Accounting Chamber of Ukraine; and

— effective monitoring and coordination by the National Council on Anti-corruption Policy.

63
As well as the creation of adequate structures, the main challenges are genuine law enforcement and the independence of Justice. At the end of 2015, the political will to combat corruption as proclaimed by the post-Maidan government had not yet produced a convincing track record of investigations and sanctions for high-level corruption cases. Experts point out that FAC in Ukraine was stalling because enforcement institutions were not sufficiently independent of the government and oligarchs were exerting influence over political parties[55]. Ukraine's poor track record on high-level corruption is jeopardising its international rescue package[56].

55 See, for example, the National Integrity System Assessment Ukraine 2015, Transparency International, 2015 which was produced as part of the EU-funded project 'National Integrity System Assessment in the European Neighbourhood East region'.

56 See e.g. Statement by Christine Lagarde, Managing Director of the International Monetary Fund (IMF), Press Release No 16/50, 10 February 2016.

Part II — Effectiveness of EU assistance in improving governance in the gas sector, and security of the EU's gas supply via Ukraine

64

We examined whether EU–Ukraine dialogue addressed gas and energy efficiency issues in an effective way, whether EU assistance to improve governance in the gas sector and the security of the EU's gas supply via Ukraine was appropriately designed and monitored, and whether it produced tangible and sustainable results. We assessed governance aspects in the gas sector against the EU objectives of developing a competitive, transparent and non-discriminatory gas market, in convergence with EU rules and standards[57]. This included consumer information and protection, price transparency, accountability of utility companies, transparent reporting on gas market and promotion of energy efficiency. The main documentary evidence used for our findings, and discussed with the auditees, were the joint EU–Ukraine reports on the implementation of the Memorandum of Understanding on energy cooperation, Council conclusions, EU Parliament reports, the Commission strategy and programming documents, and Commission management reports. Reports from external sources such as International Energy Agency, Oxford Institute for Energy Studies, World Bank, IMF and CSOs were also used.

Inconsistent commitment and approach to reform hampered EU–Ukraine dialogue until recently

Gas sector dialogue was broad but of limited effectiveness

65

The Memorandum of Understanding (MoU) on energy cooperation signed by the EU and Ukraine in 2005 establishes roadmaps and addresses the main energy issues[58] in Ukraine. We consider it a major achievement that Ukraine became a contracting party to the Energy Community Treaty[59] in February 2011. Moreover, since 2014 it has made efforts to fulfil its commitments under the Treaty, in particular by implementing the 3rd EU legislative energy package[60] a key EU–Ukraine energy cooperation priority.

57 Based on Chapter I of Title V of the Association Agreement.

58 Including, for the gas sector, price reforms, social security nets, energy efficiency, diversification of supply and modernisation of infrastructures.

59 The Treaty establishing the Energy Community was signed in 2006. The parties commit themselves to liberalise their energy markets and implement key EU legal acts in the area of electricity, gas, environment and renewable energy.

60 The latest round of EU energy market legislation, known as the third package, was enacted in 2009 in the EU to improve the functioning of the internal energy market and resolve structural problems.

66
Until 2014, high-level EU–Ukraine dialogue on energy cooperation was of limited effectiveness in terms of restructuring the gas sector due to a lack of genuine commitment by the Ukrainian partners. Many of the same major issues arose in the period 2007 to 2015 and progress on modernising the gas transit system was limited. The Commission's efforts to bring Ukraine's energy prices to economically justified levels or to reduce the Naftogaz deficit were unsuccessful in the 2007-2013 period. However, the Commission was successful in avoiding major disruptions to the EU's gas supplies in 2014 and 2015 despite the crisis between Ukraine and Russia (see paragraph 68).

Gas sector dialogue suffered from EU stakeholders' diverging views and wavering Ukrainian commitment

67
There were diverging views among the Member States, as well as between Member States and the Commission, regarding priorities for the security of the EU's gas supply via Ukraine and the need for urgent action. 'Speaking with one voice' on such priorities therefore remained a challenge, despite the Commission's efforts. The high-level EU communication clearly advocated the strategic nature of Ukrainian gas transit. At the same time, the communication was not explicit about how the frail economic and financial situation both of the country and of the state energy company Naftogaz, exacerbated by systemic corruption in the gas sector, could affect Ukraine's reliability as a gas transit country.

68
Gas transit via Ukraine is hugely important for the security of supplies in central, southern and eastern Europe and it also has important economic, financial and social consequences for Ukraine itself. In 2014, the EU reacted swiftly when Gazprom stopped gas deliveries to Ukraine and a potential threat emerged to the security of gas transit through Ukraine: the EU offered alternative solutions for gas supplies to Ukraine by facilitating reverse flows and supporting new interconnections in order to secure continued transit through the country.

69
The persistent lack of a sufficiently stable Ukrainian energy strategy (except for Ukraine's gas transit role) and fluctuating political will made it more difficult for the Commission to adopt a consistent approach to the EU–Ukraine gas dialogue in a complex geopolitical environment.

Conditions for EU assistance were broad in the early phase

70

Some conditions included in the 2007 Energy I budget support programme were not precise enough to avoid conflicts of interpretation with the Ukrainian authorities[61]. Given this lack of precision and the fact that the programme allowed only three different completion rates for the fulfilment of the condition (0-50-100 %) the Commission sometimes had to be accommodating in its assessment[62]. Furthermore, due to urgent macro-economic and political considerations, many energy conditions agreed by the Commission and the Ukrainian Authorities in MFA I were also defined in a broad way[63].

EU assistance lacked high-quality data until 2014

71

Ready-to-use and reliable data, even in adverse conditions, are essential for well-founded, evidence-based decision-making. Until 2014, the availability of ready-to-use and reliable data was problematic, e.g.:

— Gas flows transiting Ukraine on a daily basis;

— Regular data on gas transit fees actually collected by Ukraine[64];

— Comprehensive summary statistics on actual gas and heating tariff hikes.

Some improvements were noted in 2014 as regards Commission access to data on gas transit via Ukraine and since 2015 Ukraine's Transmission System Operator has been making information on daily gas transit flows available online.

72

The joint EU–Ukraine annual progress reports on the implementation of the 2005 energy Memorandum of Understanding provided a useful forum for regular political dialogue on key energy challenges. However, we found that they were not critical enough and did not fully reflect the Commission's perspective.

EU assistance until 2014 had limited impact on the gas sector

73

Until early 2015, EU assistance was not successful in producing a breakthrough in the Ukrainian gas sector[65], but important milestones/progress have since been achieved (see also ***Figure 3***):

61 See, for example, the 'No increase in the quasi-fiscal deficit in the energy sector compared to 2006' condition. The Commission and the Ukrainian partners interpreted the condition differently and proposed a fulfilment rate of 0 % and 100 %, respectively.

62 E.g. for indicator 6 (Finalisation with the international financial institutions (IFIs) of the financing agreements for priority infrastructure projects), indicator 5.3 (Presentation for commissioning the gas metrology line in the Regional Metrology Centre in Boyarka) and indicator 8 (Design and construction of a pilot international gas metering station at an entry point into the gas transit system of Ukraine).

63 Examples are 'increase substantially the overall collection rate of Naftogaz', 'achieve substantial progress in the implementation of Ukraine's obligations under the Energy Community Treaty', 'make substantial progress towards achieving EITI (Extractive Industries Transparency Initiative) compliant status', 'strengthen in a targeted manner the social safety net' and 'substantially expand the utilisation of individual gas meters'.

64 Fee collection can be calculated, but only in theory by using an established formula based on gas transit contracts.

65 To illustrate this point, the related EU energy sector budget support conditions (Energy I and Energy Efficiency) were only partially fulfilled, i.e. at a rate of 59 %. The Commission and the Ukrainian authorities disagreed in numerous cases over actual fulfilment rates.

Figure 3

Energy and gas sector developments in Ukraine, 2007-2015

Areas/ sub areas		Developments in 2007-2013	Developments in 2014-2015	Comments
(a) Gas sector reform	Gas law	• Incremental progress with no breakthrough. • Better integration of Ukraine into the EU's energy market is given impetus by Ukraine's accession to the Energy Community Treaty.	• Adoption of a comprehensive gas sector reform action plan (March 2015) and the Ukrainian gas law of April 2015.	• 2015 was a positive turning point in gas sector reform. After the April 2015 gas law, the preparations for unbundling Naftogaz commenced in line with the EU third energy package.
	Gas and heating prices	• Insufficient increases between 2007 and 2013 (despite EU and IMF requirements).	• Utility prices increased substantially.	• Further substantial increase in gas prices in April 2016.
		• No reduction in Naftogaz's deficit.	• Naftogaz's deficit decreased significantly in 2015.	• Naftogaz's deficit should disappear by 2017.
	Social safety net	• Unsuccessful efforts to set up a robust system to compensate the poorest members of society for energy price increases.	• Social compensation scheme was improved to counterbalance the vast scale of energy price hikes in 2015.	• Robustness of the compensation scheme is yet to be seen.
	Metering throughout the gas supply chain	• Significant progress on installing gas meters in individual households.	• The 2015 gas sector reform action plan aims to improve metering throughout the gas chain.	• Installation of gas meters for all remaining unmetered households and at least one heating meter per building to be completed by April 2017.
(b) Energy efficiency		• Not a priority in the Ukrainian energy reform programme (despite Commission's efforts).	• Some recent positive developments (new EU projects and programmes with EU support).	• More efforts in this area since 2015.
(c) Modernisation of the gas transit system		• No modernisation triggered by EU assistance (loan conditions not met by the Ukrainian partners).	• First pipeline modernisation works to start in 2016 (funding guaranteed partially by EU).	• Gazprom threatens to put an end to the Ukrainian transit of Russian gas in 2019.
(d) Security of gas supply via Ukraine		• Crisis situations in 2005-2006, 2009.	• Difficulties in 2014-2015 but gas transit and deliveries sustained thanks to the EU's efforts (via interconnections, reverse flows and mediation with Gazprom and Naftogaz).	• Other rival transit projects attempt to bypass Ukraine. • Improvement in gas sector governance and better integration into the EU's energy market.

Source: European Court of Auditors.

(a) Gas sector reform: Despite EU efforts, progress between 2007 and 2013 was slow. However, the implementation of the assistance conditions set by the EU and its partners has relaunched the gas sector reform since 2014 (see ***Box 5***):

Box 5

Developments since 2014 in the gas sector

- A comprehensive gas sector reform action plan establishing specific time-bound actions was adopted, as was a new gas law.
- After insufficient attempts during a difficult period of economic crisis and an increase in Russian gas prices, charges increased by approximately 300-600 % for household gas and by about 70 % for district heating at the beginning of 2015. The hikes are due to continue until 2017 until prices reach market parity level. Naftogaz's deficit was significantly reduced in 2015 and should disappear by 2017[66].
- In 2015, an existing social compensation scheme was extended to offset the vast energy price hikes imposed on the poorest members of society. However, further incremental improvements — or a reform — are needed in order to cope with future price increases and to create more effective energy-efficiency incentives.
- The 2015 gas sector reform action plan aims to improve metering throughout the gas chain.

66 An IMF objective.

(b) Energy efficiency: The Ukrainian authorities did not consider energy efficiency a priority in their energy reform programme, despite its prominence in the 2005 EU–Ukraine Memorandum of Understanding on Energy Cooperation. Since 2015, the Ukrainian authorities have paid more attention to energy efficiency.

(c) Modernisation of the gas transit system: from 2006 onwards, the Commission attempted to generate financing through international financial institutions' (IFI) loans to modernise the gas transit system. In 2012 the Commission financed a preparatory study which concluded that modernisation would cost 2.5-5.3 billion euros, depending on gasflow scenarios. The EIB and the EBRD were able to sign the first IFI loan agreements with Ukrtransgaz[67] — for 150 million euros for either IFI[68] only in December 2014 when Ukraine was deemed to have made sufficient progress on certain key conditions agreed in the Joint Declaration of 2009. Construction will start in 2016 and is expected to end in 2018 under the first phase of a large-scale project to modernise the Urengoy-Pomary-Uzhgorod transit pipeline.

67 Subsidiary of Naftogaz in charge of transmission and storage of gas.

68 The EIB loan is covered by a comprehensive EU guarantee.

(d) Security of gas supplies via Ukraine:

(i) During the audited period, the security of the EU's gas supply via Ukraine was still at risk due to the country's political, administrative and economic instability. This further worsened the crisis situations in 2005-2006 and 2009, with further difficulties in 2014-2015. In addition, it is uncertain that gas will continue to transit to EU countries through Ukrainian territory: Gazprom is threatening to put an end to the Ukrainian transit of Russian gas in 2019 when the current Gazprom-Naftogaz contract expires. Furthermore, alternative gas transit projects (e.g. Nord Stream II, Turkstream, Southstream) endeavoured or are endeavouring to bypass the country. However, the EU's objective is to maintain gas transit through Ukraine.

(ii) The Commission's recent efforts to maintain gas transit via Ukraine in 2014-2015 were successful, significantly reinforcing the security of EU and Ukrainian gas supplies via interconnections and reverse flows, and mediating between Naftogaz and Gazprom in negotiations for the so-called 2014-2015 'winter package'. Ukrainian storage facilities, which are indispensable for the security of eastern EU gas supplies, were successfully replenished in the 2015-2016 winter package using Naftogaz own resources and also an IFI loan facility[69].

(iii) Gas sector reform is expected to improve gas sector governance in Ukraine, thereby containing the governance risk element of the security of Ukrainian gas transit. Another success for the Commission was Ukraine's accession to the Energy Community Treaty in 2011, which aims to integrate the country more fully into the EU's energy market, thereby helping to stabilise Ukraine's gas sector in the long term.

69 300 million USD provided by the EBRD, supported by a Ukrainian sovereign guarantee, to be followed up by a World Bank facility of up to 520 million USD, guaranteed by the EIB and therefore by the EU.

Conclusions and recommendations

74

On the basis of our audit work, we conclude that, overall, EU assistance to Ukraine has been partially effective in supporting the country's transformation into a well governed state in the areas of public finance management, the fight against corruption and the functioning of the gas sector.

Effectiveness of EU assistance to Ukraine in improving public finance management and the fight against corruption

75

EU assistance to Ukraine was partially effective in improving public finance management and the fight against corruption.

76

During most of the audited period, PFM occupied a modest place in EU–Ukraine dialogue. However, from 2011 the EU became more demanding as regards PFM reforms and helped Ukraine to develop its 2013 PFM reform strategy and action plan (see paragraphs 31 to 34). FAC has regularly been on the EU–Ukraine dialogue agenda. It has been reinforced by the 2011 Visa Liberalisation Action Plan and further accelerated by improved post-Maidan cooperation (see paragraphs 35 to 37).

Recommendation 1 — Place greater emphasis on public finance management in the dialogue process with Ukraine

In order to maintain the PFM reform momentum created by the adoption of the 2013 PFM strategy, the Commission and EEAS should consolidate policy dialogue on PFM issues. The Commission should also explore the possibility of launching a specific programme to ensure PFM reform is implemented effectively as soon as possible.

77

The design of EU assistance was partially effective in contributing to improvements in PFM and FAC. The Commission incorporated the need to strengthen PFM and FAC into the design of the budget support programmes and MFA for Ukraine, albeit sometimes with shortcomings in the way conditions were stipulated or the method fulfilment was assessed (see paragraphs 38 to 40). Most budget support programmes in Ukraine were designed to disburse a significant proportion of the allocated amount at the beginning of the programme once general conditions had been fulfilled. This approach may lessen the incentive to implement the reforms upon which subsequent smaller payments depend. To address the critical situation of Ukraine, the Commission focused on rapid disbursement of assistance in 2014 (see paragraphs 41 to 44).

Recommendation 2 — Improve the design of conditions for and disbursements of financial assistance

The Commission should build on the experience acquired in Ukraine to improve the way future assistance is designed:

(a) For budget support and MFA loan conditions, all selected indicators should be clearly defined to avoid any disputes during the assessment process.

(b) Future loan and grant conditions should complement and reinforce each other.

(c) When negotiating and setting conditions, the Commission should work closely with other donors, in particular international financial institutions, so as to increase incentives for reform.

(d) The programmes should seek a reasonable balance between policy leverage aspects and the need to disburse assistance rapidly. Furthermore, in the case of budget support, the amounts attached to PFM and FAC conditions in variable instalments should be significant enough to ensure conditions are fulfilled.

78

Monitoring of the way EU assistance was implemented was largely effective and improved during the audited period. EU and international organisations regularly assess the situation of PFM and FAC in Ukraine and, since 2012, the Commission has strengthened its budget support monitoring framework. However, there is no systematic approach for evaluating budget support programmes (see paragraphs 45 to 48). Suspensions of budget support payments advanced PFM priorities in 2011-2013 (see paragraph 49).

Recommendation 3 — Strengthen monitoring of the way EU assistance is implemented

To deepen and speed up PFM and FAC reforms, the Commission should reinforce its monitoring in some areas and place greater emphasis on beneficiary accountability:

(a) The Commission's approach to evaluating the budget support programmes implemented in Ukraine should be streamlined.

(b) Given the results obtained by suspending payments, the Commission should, where duly justified by lack of satisfactory progress in reforms, make use of budget support payment suspensions.

79

EU assistance was partially effective in producing tangible and sustainable results in PFM and FAC. Until 2014, the Ukrainian government's limited commitment to the reform process was reflected in the incomplete and delayed achievement of expected results (see paragraphs 50 to 51). Despite the new impetus for reform since 2014, the results achieved so far remain fragile. In the MFA programmes, the Commission used its margin of appreciation to conclude that the majority of PFM conditions had been broadly fulfilled despite some shortcomings in implementation (see paragraph 52). In the case of PFM and FAC, most of the results achieved take the form of legislative and institutional changes (see paragraphs 53 to 63). For FAC policy, the results of effective implementation remain to be seen.

Recommendation 4 — Place greater emphasis on the effective implementation and sustainability of reforms

As well as advocating legislative changes, the Commission, in cooperation with civil society organisations, should make further EU assistance conditional on effective implementation of key PFM and FAC reforms. This relates in particular to the PFM reform strategy and action plan and the financial sustainability of operational impartial bodies fighting corruption. Disbursement conditions should be strictly assessed.

EU assistance to improve governance in the gas sector and the security of the EU's gas supply via Ukraine

80
Overall, EU assistance to Ukraine was partially effective in improving governance in the gas sector and the security of the EU's gas supply via Ukraine.

81
EU–Ukraine dialogue on energy issues was affected by wavering Ukrainian commitment until recently and by diverging views among EU stakeholders as regards the security of the EU's gas supply via Ukraine. The same major issues arose in the period 2007 to 2015 (see paragraphs 65 to 69).

82
In the early phase, the design of reviewed EU assistance in the gas sector and the security of gas supplies via Ukraine included certain conditions that were vague and difficult to assess (see paragraph 70).

83
Monitoring of the implementation of EU assistance lacked high-quality data until 2014 and EU–Ukraine joint reporting sometimes did not provide the full background for the difficulties experienced in the gas sector (see paragraphs 71 to 72).

84
Until 2014, EU assistance had limited impact on the functioning of the Ukrainian gas sector and produced mixed results as regards the security of the EU's gas supplies via Ukraine. Important milestones have been achieved since 2014 (see paragraph73).

Recommendation 5 — Take steps to make EU assistance to Ukraine in the area of gas more effective

The Commission should take without delay steps to improve monitoring of EU strategic gas cooperation with Ukraine and make it more effective. In particular, greater emphasis should be placed on data collection, verification and analysis. The Commission should systematically collect more accurate and verifiable information, even in adverse conditions. This is of vital importance for well founded, evidence-based decision-making.

This report was adopted by Chamber III, headed by Mr Karel PINXTEN, Member of the Court of Auditors, in Luxembourg at its meeting of 8 November 2016.

For the Court of Auditors

Klaus-Heiner LEHNE
President

Programmes examined

Table 1 — Ukraine: Budget support programmes, 2007-2015

	Allocated	Disbursed
	(in million euro)	
Sector Budget Support Programmes[1] (abbreviation, decision year)	**588**	**259**
Support for implementation of Ukraine's energy policy (Energy I, 2007)	87	73
Support for implementation of Ukraine's strategy in the area of energy efficiency and renewable sources of energy (Energy Efficiency, 2008)	70	52
Promoting mutual trade by removing technical barriers to trade between Ukraine and the EU (Trade, 2008)	45	29
Support for implementation of an Environmental Strategy in Ukraine (Environment, 2009)	35	24
Support for implementation of Ukraine's transport strategy(Transport, 2009)	65	27
Support for Border Management Sector Policy in Ukraine (Border Management, 2010)	66	49
Continued support for implementation of Ukraine's Energy Strategy (Energy II, 2012)	45	5
Sector Policy Support Programme — Support for Ukraine's Regional Policy (Regional, 2013)	55	0
Reform to Ukraine's Administrative Legal Framework and Civil Service (2011)	70	Cancelled
Budget Support for Ukraine's Regional Development Policy (2012)	50	Cancelled
State Building Contract[2]	**355**	**250**

1 The amount includes the complementary support component (technical assistance, audit, programme reviews and evaluations).

2 Of the 355 million euros for the SBC, 232 million euros were new funds and 123 million euros were absorbed from the 2013 Annual Action Programme allocations (i.e. from two new Sector Policy Support Programmes for Removing Barriers to Trade and for implementation of an Environmental Strategy in Ukraine (55 million euros each), and 13 million euros from a budget increase initially meant for the environment sector).

Source: CRIS as at 31.12.2015.

Table 2 — Ukraine: Overview of EU macro-financial assistance, 2007-2015

Decision year	Audit abbreviation	Allocated	Disbursed
		(in million euro)	
2002	MFA I	110	610
2010		500	
2014	MFA II	1 000	1 000
2015	MFA III	1 800	600
	Total	**3 410**	**2 210**

Source: DG Economic and Financial Affairs as at 31.12.2015,
http://ec.europa.eu/economy_finance/international/neighbourhood_policy/ukraine_en.htm

Table 3 — Ukraine: examined projects for the 2007-2015 period

Title (contract year)	Allocated	Disbursed
	(in million euro)	
Public Finance Management (PFM)		
Twinning 'Strengthening the enforcement of competition law and policy in Ukraine (2007)'	1	0.9
Twinning 'Assisting the Main Control and Revision Office of Ukraine (KRU) in implementing the new system of Public Internal Financial Control' (2007)	1.1	1.1
Harmonisation of competition and public procurement systems in Ukraine with EU standards (2008)	4.4	4.4
Strengthening NBU potential through the approximation to EU standards of central banking (2009)	1.1	0.6
Supporting Ukraine's Ministry of Finance in the fields of Public Debt Management and Budgetary Forecasting (2010)	1.7	1.5
Development of the fiche for the Twinning project on risk-based supervision of non-bank financial institutions (2011)	0.1	0.1
Supply of IT equipment for integrating the regional network of Ukraine's Antimonopoly Committee in support of the EU–Ukraine 2006 Action Plan project 'Harmonisation of Competition and Public Procurement systems in Ukraine with EU standards' (2010)	0.2	0.2
Extension of contract 147-509 'Harmonisation of Competition and Public Procurement Systems with EU standards' (2011)	1.1	1.1
Development of three twinning projects in the area of public finance management in Ukraine (2013)	0.1	0.1
Harmonisation of Ukraine's public procurement system with EU standards (2013)	4	2.7
What the State Costs: Promoting Public Monitoring of the State Budget Process (2013)	0.3	0.2
Civil society and media for transparent local budgets (2013)	0.3	0.1
Creation and implementation of the 'Open Budget' system for monitoring the use of public funds (2013)	0.3	0.2
Independent monitoring of resource and finance flows from the development of conventional and unconventional hydrocarbons in Ukraine within Production Sharing Agreement (2013)	0.2	0.2
Total PFM	**15.9**	**13.4**
Fight Against Corruption (FAC)		
Support for Good Governance: Project against Corruption in Ukraine (2006)	1.5	1.4
Project to Support Justice Reforms in Ukraine (2013)	8.6	2.4
Total FAC	**10.1**	**3.8**

Source: CRIS as at 31.12.2015.

Replies of the Commission and of the EEAS

Executive summary

III

The dramatic events in Ukraine at the end of February 2014, namely the ousting of former Ukrainian President Yanukovich on 28 February 2014 and the illegal Russian annexation of Crimea in the following days, required a decisive and swift response to mitigate to the extent possible the effects of a dire and unexpected situation.

Although doing so did not provide the Commission with sufficient time to develop a predefined, long-term strategy before announcing an important aid package for Ukraine in March 2014, longer-term planning began in the immediate aftermath and ample strategic discussions have taken place since, also including the involvement of international partners.

V

The Commission considers that, even though EU assistance was partially effective, important structural reforms in nearly all areas described in paragraph IV have been triggered or supported by EU programmes.

VI

The Commission had to negotiate and assess Macro-Financial Assistance and budget support conditionality in an exceptional political, economic and financial context in Ukraine.

Most budget support programmes include a fixed tranche component to be disbursed at the beginning of the programme upon fulfilment of the standard general conditions for budget support operations.

VII

Cooperation with Ukraine in the energy sector over the past 10 years was based on the 2005 Memorandum of Understanding on Cooperation in the Field of Energy and focused on ensuring the security of gas supplies to Europe via the Ukraine pipeline system and the introduction of wide-ranging reforms in the energy sector. This was also the main objective of the Joint Declaration on the Modernisation of the Ukrainian Gas Transit System of March 2009. The 2009 gas crisis further increased the relevance and timeliness of this initiative, even though its implementation was difficult due to the complex political situation in the country and the continued geo-political tensions.

Progress made allowed EIB and EBRD to sign a first set of loans for the modernisation of the gas transit system in December 2014. The efforts to improve the governance of the gas sector in Ukraine as well as the overall security of supply were impaired until 2014 by Ukraine's dependence on Russian energy supplies. Since then, the significant progress achieved in gas market reforms in Ukraine is widely recognised.

Since March 2015 a wide ranging gas sector reform plan is being implemented. Further to the new gas law, the government adopted the plan for the unbundling of Naftogaz from the transmission system operator in July 2016 which should be implemented by 2017.

The Commission, together with the Energy Community Secretariat and other partners, will continue to push for the completion of the gas sector reforms, to improve transparency and ensure full competitive conditions, including enabling new entrants to the market and increasing the security of gas supply and the reliability of Ukraine's transit system.

Introduction

04

Since mid-2015, Ukraine's economy has witnessed signs of economic stabilisation following a particularly deep recession that was largely driven by the confidence loss and damage of production capacity associated with the armed conflict in the east. The stabilisation reflected a combination of factors such as a strong macroeconomic policy response that was used to address long-term imbalances and large-scale international financial and technical support that was instrumental for reining in the confidence crisis.

Following contraction of 6.6 % in 2014 and 9.9 % in 2015, the economy is expected to return to growth (projected at 1-2 %) in 2016 on the back of gradually improving consumer and investor confidence. GDP increased by 0.1 % in real terms in Q1 2016 and rose by 1.3 % in Q2.

08

Due to the situation in Ukraine, ENI assistance since 2014 has indeed been provided in the form of annual 'Special Measures'. Preparations have now started to return to normal multi-annual programming in the form of a Single Support Framework starting from 2018.

13

The Commission agrees that the reform commitment of the Ukrainian authorities has greatly improved since 2014. In particular, the current Ukrainian administration is showing a strong commitment to Public Administration Reform (PAR).

The Commission is building on and encouraging this reform momentum. Work is ongoing to design a major EU assistance programme in this area to support and sustain this reform commitment. The third MFA programme also contains important PAR commitments, concerning both legislation and implementation

15

MFA does not duplicate IMF conditionality but complements it. MFA can only be disbursed if the complementary IMF programme is on track and IMF reviews continue to be concluded. This implies that the beneficiary must continue to meet IMF conditions in order to benefit from MFA disbursements.

Box 1 — Activation of the Ukrainian authorities' campaign against the oligarchy

The Commission considers that the role and relevance of the Agency for Modernisation are overstated and that there was no risk of confusion with the EU's official assistance to Ukraine.

17

The dramatic events in Ukraine at the end of February 2014, namely the ousting of former Ukrainian President Yanukovich on 28 February 2014 and the illegal Russian annexation of Crimea in the following days, required a decisive and swift response to mitigate to the extent possible the effects of a dire and unexpected situation.

Although doing so did not provide the Commission with sufficient time to develop a predefined, long-term strategy before announcing an important aid package for Ukraine in March 2014, longer-term planning began in the immediate aftermath and ample strategic discussions have taken place since, also including the involvement of international partners.

In addition, following the announcement of the support package, which was of major political relevance, specific EU support programmes were thoroughly designed taking into account and documenting financial risks as well as the activities of other donors.

18
The objective of the March 2014 financial package was to send a strong signal of political support and at the same time to mobilise short-term budgetary and fiscal as well as more long-term investment and advisory support. It hence addressed short- as well as medium- to long-term needs, the latter indeed being subject to sustained reform commitment on the side of the Ukrainian authorities.

It should be noted that only EUR 1.61 billion of MFA were part of the March 2014 financial package (combined volume of MFA I and MFA II). The proposal for a third MFA operation for Ukraine (with a volume of EUR 1.8 billion) was adopted by the Commission in January 2015, i.e. it was additional to the March 2014 package based on a comprehensive assessment of the assistance provided up to that point, its impact on economic and financial stability in Ukraine since the beginning of the crisis, and in view of the deteriorating financial situation in Ukraine in early 2015.

20
The return to multi-annual programming in the form of a Single Support Framework is foreseen as from 2018. Preparatory work has already started.

21
While there might have been some initial coordination challenges, activities of the EU Delegation in Kiev, the Support Group for Ukraine and the EU Advisory Mission are now closely coordinated and fully complementary. This is evidenced, e.g. by the joint design of a new anti-corruption support programme, that has been adopted earlier this year (June 2016).

22
This initiative has not been further pursued. The Commission further supports Ukraine in the fight against corruption and fraud through other initiatives, e.g. inter alia support to Ukraine’s new anti-corruption bodies through the anti corruption programme mentioned in the reply to paragraph 21, and support to reform of the judiciary.

24
Donor coordination by the Ukrainian governments was indeed relatively weak over most of the audited period. The current Ukrainian government is however taking steps to address and improve the situation and this is starting to have positive effects.

25
The Commission has coordinated from the beginning with the EBRD Multi-Donor Fund and has now also adopted a decision (July 2016) to contribute to the Fund.

Observations

34
The EU has indeed been very active to support the development of a PFM strategy in 2012 and 2013 which resulted in the adoption of a good quality document before the Vilnius Summit. Work is currently underway — again with the help of EU and OECD SIGMA experts — to update and further improve the PFM strategy.

38
Conditions on Public Financial Management and the fight against corruption were at the very centre of a number of EU support programmes, e.g. the State Building contract. The Commission will continue to improve the way and the criteria used to assess PFM progress.

40
The Commission considers that it used its margin of appreciation appropriately given the exceptional political and financial circumstanes in Ukraine.

Box 2 — Flexibility in setting and assessing the fulfilment of MFA conditions
The MoU for MFA I was mainly negotiated in 2010-2012 with a much less reform-oriented Ukrainian government and only ratified by the Ukrainian Parliament in 2014. Despite difficult negotiations, the Commission still managed to introduce some broad PFM conditions into this MoU.

The approach of including more than one deliverable in a condition renders it possible to state an overarching objective in a specific reform area in order to provide strategic orientation, while still providing clarity and specificity regarding the policy measures that are expected.

Common reply to paragraphs 41 and 42
The Commission considers that the proportion of frontloading of Sector Budget Support fixed tranches remained in the margins recommended by the Budget Support Guidelines and was justified by the situation in Ukraine.

43
The Commission considers that in 2014, Ukraine was on the brink of financial and ultimately political collapse. In tandem with the IMF and other international donors, the EU responded swiftly to the financial crisis in Ukraine, in particular in 2014 and the first half of 2015. Given the depth of the economic crisis in Ukraine and the size of the country (by far the biggest of the EU's eastern neighbours), it was necessary to provide significant amounts of macro-financial assistance.

46
Budget support disbursements are indeed since 2010 based on a comprehensive PFM assessment which takes into account all relevant analytical material including PEFA assessments.

48
The Commission considers that the 2014 evaluation of budget support operations in Ukraine provided a comprehensive and comparative overview and assessment.

51
The Commission is aware of this issue which was also highlighted by the budget support evaluation and is advising the Ministry of Finance to find better ways to channel EU resources.

52
The Commission considers that its assessment 'broadly fulfilled' means that, even though not every aspect of the MFA condition has been implemented, the reform objective of the condition in question has been achieved to an extent that it would not be justified to delay the related MFA disbursement.

Common Commission reply to paragraphs 67-69
The Commission maintained throughout the audited period a coherent policy in view of the strategic role of the Ukrainian gas transit system and, related to this, the need for fundamental reforms in the gas sector.

Member States largely supported the efforts of the Commission. The Commission acknowledges however that the priorities of some Member States with regard to cooperation in the gas sector were not always fully aligned with those of the Commission.

Following the crisis of 2006 and of 2009, the Commission did conduct internal risk assessments and sought to assess the lessons learned from the interruption of gas supplies in a Staff Working Paper (Commission Staff Working Paper {COM(2009) 363} SEC (2009) 997).

The Commission considers that gas transit interruptions in 2006 and 2009 were a direct result of a commercial dispute between Gazprom and Naftogaz, influenced and exacerbated by the political tensions between Ukraine and Russia.

The Commission had to take into account the sensitivity of the related information and considers it could, under these circumstances, not have been more explicit.

70
The Commission acknowledges that the design of assistance programmes relating to the gas sector could have been in some cases better but points to the weak administrative capacity of the concerned Ukrainian ministries in formulating assistance programmes.

71
The Commission considers that access to data gradually improved during the audited period. Since 2015, relevant data regarding gas transit flows as well as market information concerning the Ukrainian gas sector are now publicly accessible, thanks to the cooperation between Ukrainian authorities, the Commission and ENTSO-G (European Network Transmission System Operator-Gas).

73
The Commission considers that progress was already made in 2014, including for example the drafting of the new gas law by the government, that enabled the signature of first EIB/EBRD loans for the modernisation of the Gas Transit System in December 2014.

(c)
The Commission's efforts to help Ukraine in the modernisation of the gas transit system only generated major concrete investment decisions towards the end of 2014 mainly because previous governments were not forthcoming in implementing key reforms agreed in the Joint Declaration of 2009.

(d) (i)
The Commission and EEAS consider that the security of the EU's gas supply via Ukraine was also at risk because of external actors (Russia).

Conclusions and recommendations

74
The Commission and EEAS consider that the EU assistance played a key role in promoting the political association and economic integration of Ukraine with the EU. Since the onset of the crisis in 2014, the EU assistance played also a key role in stabilising the situation in Ukraine and in triggering important structural reforms across a wide range of areas and sectors.

76
The Commission considers that the fight against corruption and Public Financial Management are key issues in the EU's dialogue with Ukraine. As a consequence, over the last years a number of important reforms have been launched and are showing important results.

Recommendation 1 — Place greater emphasis on public finance management in the dialogue process with Ukraine

The Commission and EEAS accept the recommendation.

A specific PFM support programme is currently under consideration as a 2017 Special Measure. PFM issues are already key elements of all ongoing budget support programmes and an update of the PFM strategy is underway with the help of EU and OECD-SIGMA experts.

77

The Commission considers that quick mobilisation and disbursement of assistance was crucial in 2014 and 2015 due to the critical situation in Ukraine. All budget support payments were based on a thorough assessment to ensure that the general conditions for budget support were being met.

Most budget support programmes include a fixed tranche component to be disbursed at the beginning of the programme upon fulfilment of the standard general conditions for budget support operations.

Recommendation 2 — Improve the design of conditions for and disbursements of financial assistance

The Commission accepts the recommendation.

(a)

The Commission has already started to define policy objectives in a more precise and targeted manner, as can be seen in the evolution of Memoranda of Understanding (MoU) with Ukraine in particular between MFA II and III. The Commission will make further efforts for clarity and precision in the future.

However, MFA conditionality is always an outcome of a negotiation with the beneficiary country. In particular where these negotiations take place in an exceptional geopolitical and financial context, the Commission may, also in the future, have to strike a balance between urgency considerations as well as the extended timeframe of assistance on the one hand and precision and clarity on the other.

(c)

The Commission will continue for all its MFA programmes, as it has always done in the past, to coordinate closely with the IMF and other donors.

(d)

The Commission will also continue to strive for a reasonable balance between leverage and speed of disbursement. In 2014 the exceptional geopolitical and financial context in Ukraine justified, on occasions, to err on the side of rapid disbursement of MFA. As economic stabilisation started to take hold in Ukraine in late 2015, the Commission has been more demanding with respect to implementation of MFA conditions. This is underlined by the fact that the second tranche of MFA III has been on hold since October 2015 as implementation is as yet incomplete.

The Commission will continue to monitor implementation closely, with a view to making best use of the leverage function of its assistance. At the same time, it cannot be ruled out for the future that MFA tranches might be disbursed in a context of a good implementation record overall, even when a small number of conditions are not fulfilled.

78

The Commission considers that the 2014 evaluation of budget support operations in Ukraine provided for a comprehensive and comparative assessment.

Recommendation 3 — Strengthen monitoring of the way EU assistance is implemented

The Commission accepts the recommendation.

The Commission will continue to work on strengthening monitoring of EU assistance implementation and will use all tools at its disposal to speed up progress in reforms.

79

The Commission considers that its assessment 'broadly fulfilled' means that, even though not every underlying detailed aspect of the MFA condition has been implemented, the reform objective of the condition in question has been achieved to an extent that it would not be justified to delay the related MFA disbursement.

Recommendation 4 — Place greater emphasis on the effective implementation and sustainability of reforms

The Commission and EEAS accept the recommendation.

For MFA, when assessing the disbursement conditions, the Commission will restrict itself to the assessment categories 'fulfilled', 'broadly fulfilled' and 'not fulfilled'.

80

Cooperation with Ukraine in the energy sector over the past 10 years has focused on ensuring the security of gas (and oil) supplies to Europe via the Ukraine pipeline system. The efforts to improve the governance of the gas sector in Ukraine as well as the overall security of supply were impaired by the political situation and Ukraine's dependence on Russian energy supplies. The high-level energy dialogue carried out in the context of the Memorandum of Understanding of 2005, provided in this regard an essential and useful forum.

81

The Commission maintained throughout this period a coherent policy in view of the strategic role of the Ukrainian gas transit system and the need for fundamental reforms in the gas sector. This has been acknowledged also by the Council in a number of conclusions on this matter. While Member States largely supported the efforts of the Commission, the priorities of some Member States with regard to cooperation in the gas sector was not always aligned with those of the Commission.

82

Despite shortcomings, the Commission considers that both the budget support programmes as well as related technical assistance projects allowed some progress to be made on the critical reform agenda in the gas sector as well as in increasing security of supply, despite often adverse political conditions. See also Commission reply to paragraph 70.

83

The Commission considers that communication and access to data gradually improved as the energy dialogue evolved (see also Commission reply to paragraph 71). The Commission addressed the key challenges experienced in the gas sector in its regular energy dialogue, even if the joint reporting did not always provide the full background.

Recommendation 5 — Take steps to make EU assistance to Ukraine in the area of gas more effective

The Commission accepts the recommendation and has already started implementing it.

Significant steps have already been taken to make EU assistance more effective, including the establishment of a team of energy experts within the Support Group for Ukraine, improved and closer coordination of assistance with the Energy Community Secretariat as well as with other stakeholders (donors, ENTSO-G,etc.).

The Commission is in the process of upgrading its Memorandum of Understanding on the cooperation in the energy field with Ukraine and intends to sign a Strategic Energy Partnership by the end of 2016 with a view to further intensifying its energy dialogue with Ukraine and enhancing the effectiveness of cooperation in the energy sector.

The Commission also continues its efforts to mediate in the ongoing gas dispute between Russia and Ukraine, including through a close monitoring of gas transit flows. An early warning system is in place under the Association Agreement with Ukraine.

Further actions will be taken to improve the quality of statistical data collected on Ukraine, in particular through the statistical component of the EU4Energy project launched in June 2016 with the International Energy Agency and the Energy Community.

Event	Date
Adoption of the Audit Planning Memorandum/Start of audit	7.10.2014
Official sending of draft report to Commission (or other auditee)	20.7.2016
Adoption of the final report after the adversarial procedure	8.11.2016
Official replies of the Commission and the EEAS received in all languages	24.11.2016

In this report the Court examines whether Commission and European External Action Service assistance was effective in supporting the transformation of Ukraine into a well-governed state in the areas of public finance management and the fight against corruption, as well as in the gas sector during the 2007-2015 period. Overall, EU assistance to Ukraine has been partially effective in these three domains. Until 2014, EU assistance had limited impact. Despite the new impetus for reform since 2014, the results achieved so far remain fragile. This report sets out five recommendations for improving EU assistance.

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