

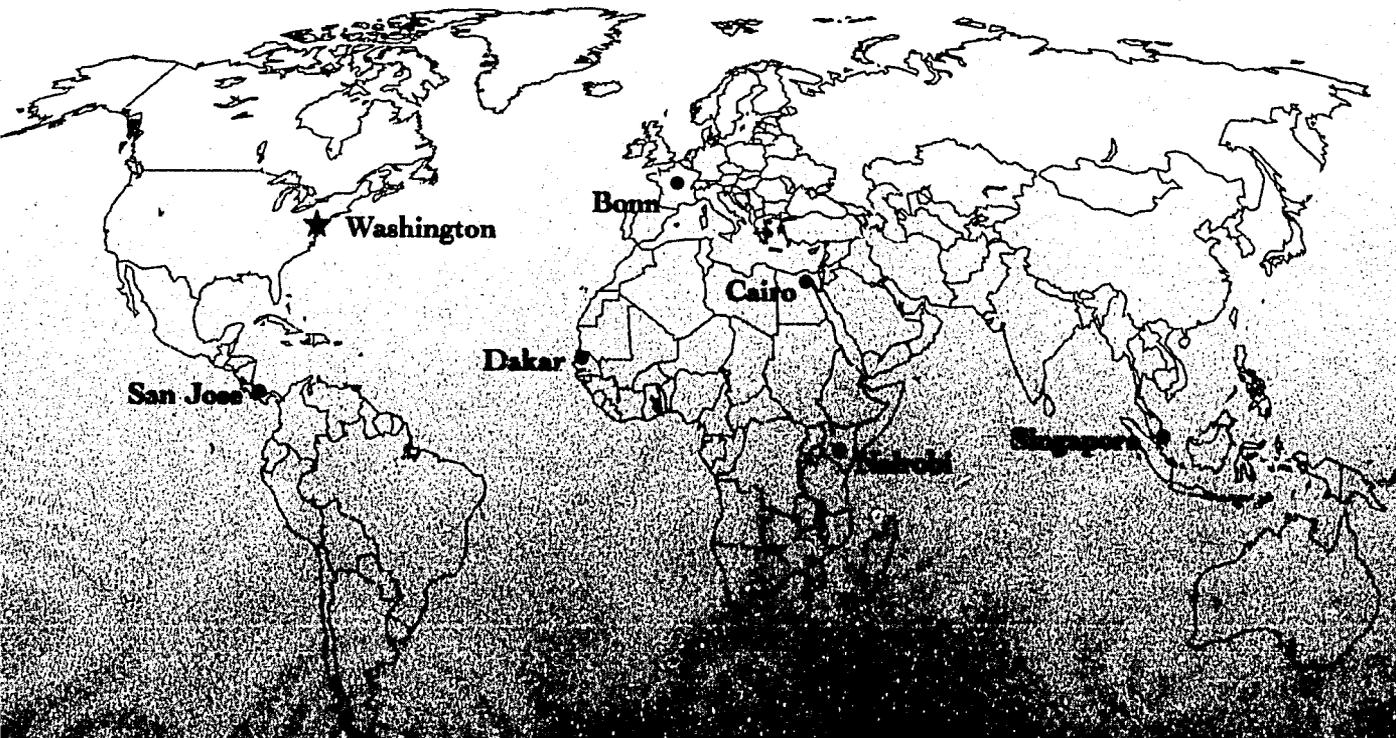
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Regional Inspector General for Audit
Bonn

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**Audit of the ENI Bureau's and USAID/Kiev's
Monitoring of a \$72 Million Energy Sector Cash Grant
to the Government of Ukraine**

Report No. 8-121-95-010
May 8, 1995



U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT





U. S. AGENCY FOR INTERNATIONAL DEVELOPMENT

OFFICE OF THE REGIONAL INSPECTOR GENERAL

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May 8, 1995

MEMORANDUM

TO: DAA/ENI, Barbara Turner

FROM: *John* RIG/A/B, *James R. Bennell* John/P. Competello

SUBJECT: Audit of the ENI Bureau's and USAID/Kiev's Monitoring of a \$72 Million Energy Sector Cash Grant to the Government of Ukraine

Our audit found that the Bureau for Europe and the New Independent States (ENI) and USAID/Kiev ensured that the Government of Ukraine (1) fulfilled the conditions precedent before disbursing the \$72 million cash grant, and (2) used grant funds for eligible purposes only. This report contains no recommendations.

Since the audit findings are positive and we made no recommendations, ENI did not provide formal written comments to a draft of this report submitted for ENI's review.

I appreciate the cooperation and courtesies extended to my staff during the audit.

Background

In January 1992 USAID authorized a \$250 million four-year Energy Efficiency and Market Reform Project (110-0002) for the New Independent States (NIS) to improve the efficiency of district heating systems and to promote energy price reform. In November 1994 USAID amended the project to authorize a \$72 million cash grant to the Government of Ukraine (GoU) to contribute to its efforts to reach the International Monetary Fund balance-of-payments deficit reduction targets and to support energy policy reform and power sector restructuring in Ukraine.

The breakdown of inter-republic trade in the NIS, combined with the foreign exchange shock of paying for Russian oil and gas at world prices, led to a substantial industrial production decline and transportation difficulties in Ukraine. These problems contributed to Ukraine's hyper-inflationary conditions, runaway currency devaluation, and a huge increase in its budget deficit. The economic situation and bleak future prospects were extremely unattractive to business and investment. Further, these conditions caused the flight of domestic capital by legal and illegal means.

After some delay, the GoU launched a massive stabilization and economic reform program in 1994 in order to attract foreign investment and donor assistance. The Government of the United States pledged \$100 million in order to help bridge a portion of the GoU's fourth quarter 1994 balance-of-payments gap. Of this amount, \$72 million was made available in the form of a cash transfer to pay for importing critically needed natural gas from Russia and for supporting energy sector reform.

Expected benefits from the cash grant included:

- sufficient natural gas for heating Ukrainian households during October 1994;
- energy supply and demand balanced by the introduction of a competitive pricing system; and
- an energy sector strengthened through the establishment of effective organizational, legal, and regulatory systems.

The cash grant included six conditions precedent which the GoU was required to fulfill before USAID disbursed the \$72 million. These conditions precedent required the GoU to implement certain energy policy reforms and establish administrative procedures for the grant. The ENI Bureau and USAID/Kiev were responsible for monitoring all aspects of the cash grant. USAID approved the cash grant on November 21, 1994, disbursed the funds to the GoU's "Separate Account" on December 21, 1994, and authorized¹ the GoU and the U.S. bank to release the funds from the account on December 29, 1994.

¹ *The Governments of the United States and Ukraine agreed that a Separate Account for the \$72 million would be established in a U.S. bank in the name of the Government of Ukraine. The account was to be interest-bearing and dollar-denominated. Funds in the Separate Account were not to be commingled with funds from any other source. The Minister of Finance of Ukraine was to manage the Separate Account, but agreed to obtain USAID's approval before releasing the funds.*

Audit Objectives

RIG/A/Bonn audited the \$72 million Energy Sector Cash Grant to the Government of Ukraine to answer the following audit objectives:

- **Did the ENI Bureau and USAID/Kiev ensure that the Government of Ukraine fulfilled the conditions precedent before disbursing the \$72 million cash grant?**
- **Did the ENI Bureau and USAID/Kiev ensure that the Government of Ukraine used the grant funds for eligible purposes?**

Appendix I contains a discussion of the scope and methodology of this audit.

Audit Findings

Did the ENI Bureau and USAID/Kiev ensure that the Government of Ukraine fulfilled the conditions precedent before disbursing the \$72 million cash grant?

The ENI Bureau and USAID/Kiev ensured that the six conditions precedent established in the grant agreement were fulfilled by the Government of Ukraine before disbursing USAID grant funds to the GoU's Separate Account.

One of the purposes of the energy sector grant was to advance energy sector reform in Ukraine. Specifically, the objectives were to move energy pricing toward international market rates and initiate power sector restructuring. To help achieve these objectives, several covenants and conditions precedent were included in the grant agreement during negotiations with the GoU. The GoU satisfied certain conditions precedent before the agreement was executed. However, before USAID would disburse the \$72 million, the GoU was required to furnish evidence showing that it had:

- introduced a system of periodic price adjustments to achieve full cost recovery for electricity producers;
- established a National Energy Regulatory Commission by December 1, 1994; and
- satisfied four standard conditions precedent: (1) providing a legal opinion regarding the validity of the agreement, (2) establishing a "Separate Account" for deposit of the \$72 million, (3) designating signatories for the account, and (4) establishing acceptable procedures regarding control of and access to, the account.

The ENI Bureau developed the following list of requirements that the GoU was to submit as evidence that it had complied with the above conditions precedent:

- a resolution executed by the Ministries of the Economy, Energy, and Vice Prime Minister regarding electricity price adjustment;
- an executed order establishing an Energy Regulatory Commission; and
- appropriate documentation concerning: (1) the validity of the grant agreement, (2) establishment of a Separate Account at a U.S. bank, (3) identification of the authorized signatories of the account, and (4) agreement regarding control of, and access to, the Separate Account.

The ENI Bureau delegated to USAID/Kiev the responsibility for receiving and approving the documentation submitted by the GoU. The ENI Bureau was responsible for confirming that the GoU had established a Separate Account. USAID's Office of Financial Management was responsible for deposit of USAID's \$72 million.

On December 19, 1994 USAID/Kiev certified (via KIEV 011061) that all conditions precedent had been met and, on December 21, 1994, USAID's Office of Financial Management disbursed the \$72 million to the Separate Account established by the GoU for this purpose.

Our review of ENI Bureau and USAID/Kiev records and discussions with appropriate officials showed that documentation existed evidencing that all conditions precedent had been met, as certified by USAID/Kiev.

- The GoU Minister of Economy forwarded to USAID/Kiev a copy of Presidential Decree No. 591/94 establishing a system for periodic price adjustments to recover the cost of electricity production.
- Although not established by the original due date, USAID/Kiev also had documentation evidencing that the GoU established a national Energy Regulatory Commission by December 8, instead of December 1, 1994.
- With respect to the four standard conditions: (1) the GoU Ministry of Foreign Affairs provided a written opinion, stating that the grant agreement was duly authorized or ratified by, and executed on behalf of, the GoU, and that the grant is a valid and legally binding obligation; (2) the State Export-Import Bank of Ukraine in a letter stated that Account No. 36112362 had been opened at Citibank N.A., New York; (3) the Prime Minister of Ukraine submitted to USAID/Kiev the names of GoU officials, together with specimen signatures, who were to act as signatories for the account; and (4) the GoU provided USAID/Kiev with a statement of the procedures governing control of, and access to, the Separate Account and a description of the documentation required to permit a release of funds from it.

Did the ENI Bureau and USAID/Kiev ensure that the Government of Ukraine used the grant funds for eligible purposes?

The ENI Bureau and USAID/Kiev ensured that the Energy Sector grant was used for the purpose of paying for natural gas imported during October 1994, as specified in the grant agreement.

According to the grant agreement, the GoU was to use the Energy Sector grant to pay for natural gas imported during October 1994. The Ukrainian natural gas importing entity (UKRGAZPROM) buys natural gas from the Russian natural gas exporting entity (GAZPROM) and then distributes the gas to two Ukrainian gas handling entities. These entities in turn distribute the gas to Ukrainian Ministry of Energy (MINENERGO) power and heating plants that provide heat and power to end-users.

Before releasing the funds from the Separate Account to the Russian supplier, the GoU was to provide USAID with evidence documenting the natural gas bill to be paid, the receipt of natural gas by Ukraine, and utilization of natural gas by MINENERGO power and heating plants.

The GoU provided USAID/Kiev various reports and documents to show that the \$72 million had been used for the purposes agreed upon. A financial consultant hired by USAID/Kiev reviewed translated copies of GoU-furnished payment documentation and concluded that the documentation satisfied the requirement for release of the grant funds. Mission officials said that they were reasonably assured that natural gas was received by Ukraine from Russia in the quantities reported for October 1994 (3,139,626 thousand cubic meters) and that the portion allocated to MINENERGO (1,655,550 thousand cubic meters valued at \$82.8 million), whose purpose was to generate electricity and heat, had been consumed by eligible users.

As further evidence that the GoU had complied with grant agreement terms, ENI Bureau officials cited a letter received from the Russian GAZPROM Chairman of the Board on December 22, 1994 via the American Embassy in Moscow. This letter included supporting documentation showing outstanding Ukrainian bills for gas supplied in October/November 1994, totaling the equivalent of \$103.5 million. These GAZPROM documents, which outlined the shipments by date, amounts paid, and payments due, showed payments due for October that were greater than the \$72 million grant. USAID/Kiev also received a letter from the Ukrainian Minister of Economy, saying that the GoU intended to use the grant funds for

payments of gas imported in October. The letter went on to say that the Russian Government had agreed to accept payment under the procedures established by the energy sector grant.

USAID/Kiev concluded that, on the basis of the foregoing documents, there was sufficient assurance that the grant would be used for eligible purposes, and approved release of the \$72 million grant.

USAID disbursed the \$72 million for the Energy Sector grant to the Separate Account at Citibank, New York on December 21, 1994. After receiving appropriate notification from both USAID and the GoU, Citibank transferred the funds to Russia GAZPROM account at Bankers Trust Company, New York, on December 29, 1994. On December 30, 1994 Citibank paid USAID \$75,420, representing interest earned on the \$72 million while on deposit in the Separate Account. On February 1, 1995 USAID deposited this amount with the U.S. Treasury.

SCOPE AND METHODOLOGY

Scope and Methodology

We audited the Energy Sector Cash Grant to Ukraine under the Bureau for Europe and New Independent States' (ENI) Energy Efficiency and Market Reform Project (110-0002). We conducted the audit in accordance with generally accepted government auditing standards. The audit was conducted from February 22 through April 14, 1995 and covered expenditures of \$72 million under the grant agreement. We conducted our audit in ENI's Washington offices and at the USAID Mission in Kiev, Ukraine. No audit work was done in Russia.

We reviewed ENI and USAID/Kiev project documentation, including the grant agreement to determine: (1) if the conditions precedent were fulfilled by the GoU prior to disbursing the grant funds, and (2) if USAID ensured that the grant funds were used for eligible purposes. We interviewed ENI officials (both in Washington and Kiev) to determine how grant activities were monitored.

To determine if the conditions precedent were fulfilled by the GoU prior to disbursing the grant funds, we reviewed the Project Authorization Memorandum and grant agreement to determine if all the relevant conditions precedent discussed during the planning process as needed to implement the cash transfer had been included in the agreement. We confirmed that the six conditions precedent included in the grant agreement were met prior to disbursement of the \$72 million.

To determine if USAID had ensured that the grant funds were used for eligible purposes, we reviewed ENI's and USAID/Kiev's documentation that showed the GoU had spent the grant funds for importing natural gas delivered in October 1994, as required by the grant agreement. We interviewed ENI and USAID/Kiev officials to determine the basis for accepting the documentation provided by the GoU and releasing the grant.

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We also obtained direct confirmation from U.S. banks involved to ensure that all interest earned while the funds were held in the Separate Account was eventually deposited with the U.S. Treasury.

The objectives of this audit did not allow for sufficient testing to comment on the general adequacy of internal controls of the ENI Bureau or USAID/Kiev. Therefore, we did not prepare a separate report on internal controls. We did, however, assess the Bureau's and Mission's internal controls for overseeing and monitoring the grant activities. The audit included tests of USAID's Office of Financial Management accounting process for providing cash transfers.
