

# State-Owned Enterprise Reform in the Hydrocarbons Sector in Ukraine





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## Foreword

This report is developed in the context of the *Project on state-owned enterprise reform in the Ukrainian hydrocarbons sector* carried out as part of the OECD-Ukraine Action Plan for the implementation of the Memorandum of Understanding between the Government of Ukraine and the OECD. The project supports the government of Ukraine in its efforts to reform corporate governance in the national hydrocarbon sector. The project was launched in January 2018 with the aim of completing the following results by March 2019:

- Identification of priority areas for analysis and initial evaluation of progress made and challenges encountered in the implementation of corporate governance reforms in the Ukrainian hydrocarbon sector, with “Naftogaz of Ukraine” (Naftogaz) – the national oil and gas company – as a case study;
- Comprehensive assessment of the Ukrainian hydrocarbon sector progress in implementing corporate governance reforms in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises, and issuance of further recommendations; and,
- Dissemination of findings amongst OECD bodies and Ukrainian government institutions involved in SOE reform.

The report is based on information volunteered by the Ukrainian authorities, including in response to a questionnaire sent in March 2018, during discussions held with Ukrainian governmental and non-governmental representatives during meetings and over 30 interviews held in Kyiv in February, May and September 2018, as well as independent research undertaken by the OECD Secretariat. Final recommendations were discussed and endorsed by the Government and Naftogaz in Paris in November 2018, at the biannual meeting of the OECD Working Party on State-Ownership and Privatisation Practices (WP SOPP).

The project is implemented with the financial support of the Norwegian Government. It is carried out in close co-operation with public institutions and key stakeholders from Ukraine, including the Cabinet of Ministers, Ministry of Economic Development and Trade, Ministry of Energy and Coal Industry, State Property Fund of Ukraine, the Presidential Administration, the Energy Parliamentary Committee, Naftogaz, Naftogaz subsidiaries and supervisory board of the newly established Main Gas Pipelines of Ukraine. Civil society, academia, private sector, business organisations, and national corporate governance institutes including the Ukrainian Corporate Governance Academy have also contributed to the OECD's assessment.

Other international organisations and partners involved in corporate governance reforms in Ukraine, including the European Bank for Reconstruction and Development (EBRD) and the United States Department of State have provided input. The project was further informed by a taskforce of national SOE policy makers and practitioners belonging to the WP SOPP and its network.



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## *Acronyms and Abbreviations*

AA	Association Agreement
CEO	Chief Executive Officer
CGAP	Corporate Governance Action Plan
CMU	Cabinet of Ministers of Ukraine
D&O	Directors and Officers
DCFTA	Deep and Comprehensive Free Trade Arrangement
DHC	District Heating Company
DSO	Distribution System Operator
EBRD	European Bank for Reconstruction and Development
ECS	European Community Secretariat
EITI	Extractive Industries Transparency Initiative
EU	European Union
GDP	Gross Domestic Product
GSM	General Shareholders' Meetings
GTS	Gas Transit System
HACC	High Anti-Corruption Court
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
JSC	Joint-Stock Company
CMU	Cabinet of Ministers of Ukraine
LLC	Limited Liability Company
LPG	Liquefied Petroleum Gas
MEDT	Ministry of Economic Development and Trade
MHE	Municipal Heating Enterprise
MGU	Mahistralny Gazoprovody Ukrainy/Main Gas Pipelines of Ukraine
MOF	Ministry of Finance
MoU	Memorandum of Understanding
NABU	National Anti-Corruption Bureau of Ukraine
NAK	Naftogaz of Ukraine
NCSREPU	National Commission for State Regulation of Energy and Public Utilities
NSSMC	National Securities and Stock Market Commission
NOPLAT	Net Operating Profit Less Adjusted Taxes

O&G	Oil and Gas
OECD	Organisation for Economic Co-operation and Development
OVDP	UAH-denominated domestic government bonds
PJSC	Public Joint-Stock Company
PP&E	Property, plant, and equipment
PSO	Public Service Obligation
RDO	Reforms Delivery Office
ROIC	Return on invested capital
RSC	Regional Supply Companies/Obligations
RST	Reform Support Units
SAGSUR	Strategic Advisory Group for Supporting Ukrainian Reforms
SAS	State Audit Service of Ukraine (formerly known as KRU)
SCMU	Secretariat of the Cabinet of Ministers of Ukraine (Secretariat of the Government)
SIC	System of Internal Control
SGSS	State Geological and Subsurface Survey of Ukraine
SOE	State-Owned Enterprise
SPF	State Property Fund
TSO	Transmission System Operator
UAH	Ukrainian hryvnia
UGV	Ukrigasvydobuvannya (Ukrainian gas producer)
UMCC	United Mining and Chemical Company
UNB	Ukrnaftoburinnya
USD	US Dollar
USU	Underground Gas Storages of Ukraine
UTG	Ukrtransgaz (Ukrainian gas transport operator)
VAT	Value Added Tax
WP SOPP	Working Party on State Ownership and Privatisation Practices

### **Units of measurement**

bcm	billion cubic metres
km	kilometre
TWh	Terawatt hours

## *Key findings*

Given the importance of Naftogaz in the Ukrainian economy, its improved governance and performance can have far-reaching effects in all segments of the society, impacting the day-to-day lives of citizens, and other parts of the business sector. Consequently, its good governance is critical to ensure its positive contribution to economic efficiency, competitiveness and energy security.

The Government has relied on Naftogaz to achieve numerous, and sometimes, conflicting objectives, and such actions towards Naftogaz due to the company's size and weight could influence state finances considerably. Naftogaz has been an important public service provider ensuring the delivery of gas to heat homes and businesses, but it has faced important challenges recuperating losses both from unpaid debts by dubious intermediaries (Francis, 2018), and inadequate compensation mechanisms for rendering such services. As the main gas producer in Ukraine, Naftogaz will be an important player to meet ambitious objectives set by the Government for increased domestic gas production. At the same time, uncertainties regarding the future of gas transit routes through Ukraine (because of its conflict with Russia) and the threat posed by competitor gas transit projects, are risks that must be mitigated to ensure maximisation of value of Ukraine's hydrocarbons assets and ensuring energy security for Ukraine.

Recognising that the stakes are high, in 2014, the Government embarked on an ambitious reform programme to support the transformation of the gas sector of Ukraine. This started with:

- enacting the Natural Gas Market Law, which aimed to facilitate the implementation of the Third Energy Package and other EU *acquis*;
- introducing transparent public service obligation (PSO) regime for categories of protected consumers;
- progressive plans to align gas prices with the market;
- specification of a gas transit operator as part of its unbundling and certification requirements (to meet commitments made to the EU); and
- introducing opportunities for more investment and private participation in the energy sector.

The transformation of Naftogaz was a key element of this broader reform process. With the support of the European Bank for Reconstruction and Development, the Corporate Governance Action Plan (CGAP) was one of the tools implemented to assist Naftogaz in adopting these new commitments. Under the CGAP, the company went through an intense period of transformation. In the case of Naftogaz, some of the achievements during this period of reform included centralising the ownership of Naftogaz and putting in place the first-ever independent supervisory board in 2016. This transformation has not been without its challenges: the resignation of a number of board members due to allegations of undue

state intervention has demonstrated the delicate nature of reform (Reuters, 2017 and Naftogaz, 2017)<sup>1</sup>. However, these changes have been no small achievement in transforming the governance mechanisms in the company. The company (and overall sector) has since turned a profit after preceding years of being loss making; and has been leading a transformation of the group based on an integrated strategy in view of energy market reforms and with the aim of making a future public offering possible.

The transformation of Naftogaz is a potential good practice example and could be an important driver in the reform of the overall SOE sector in Ukraine. On the ownership side, the Government also made some laudable advancements, including:

- approving in October 2018 a basic ownership policy for the entire SOE sector;
- passing a long-awaited Privatisation Law intended to facilitate both large-scale and small-scale privatisation transactions at the state and municipal levels; enhance the transparency and integrity of individual transactions; and provide for additional guarantees for investors; professionalising board nomination practices, including through the establishment of a selection commission and nomination committee under the CMU;
- progressively putting into place independent supervisory boards in economically important SOEs; and
- since 2014 publishing an annual aggregate ownership report for the top-100 SOEs.

Despite the important reforms implemented to date, some observers comment that the pace of reforms has slowed and that reform appetite has waned. Unfortunately, progress in the corporate governance reform of Naftogaz has at times been offset by adverse developments. Going forward, reforms should be irreversible and result in concrete and visible changes.

As concluded by this review, the Government of Ukraine needs to see through the reforms that it started in 2014. In line with OECD Guidelines on Corporate Governance of SOEs, this will require particular efforts to strengthen the state-owner's ability to professionally and effectively exercise ownership rights; while continuing to improve corporate governance practices within the company. These reforms can go a long way in potentially shielding the group from undue political interference.

Additionally, without addressing risks of corruption and breach of integrity in certain areas of the hydrocarbons sector (including notably in gas distribution and supply as well as in licensing) and in the broader reform environment, the full benefits of improved corporate governance practices cannot be realised. In parallel, the state must work towards strengthening independent regulatory authorities and competition enforcement, while reinforcing anti-corruption prevention, investigation and enforcement bodies to carry out their work.

In this regard, a set of detailed recommendations have been identified in Chapter 3 of this report as priority areas for reform addressed to the state's role as owner and shareholder of Naftogaz; and, second set of recommendation focusing on the governance of the Naftogaz group. Both sets of recommendations have bearing on the ownership and governance of the broader SOE portfolio and hydrocarbons sector more specifically. These recommendations draw on the OECD SOE Guidelines as a point of departure should serve as a Roadmap for the Government and Verkhovna Rada of Ukraine to continue to undertake reform of SOEs.

<sup>1</sup> [Reuters \(2017\), Board of Ukraine's Naftogaz resigns, cites reform blockage by govt, https://www.reuters.com/article/ukraine-naftogaz-board/board-of-ukraines-naftogaz-resigns-cites-reform-blockage-by-govt-idUSL5N1M05DU](https://www.reuters.com/article/ukraine-naftogaz-board/board-of-ukraines-naftogaz-resigns-cites-reform-blockage-by-govt-idUSL5N1M05DU)  
<http://www.naftogaz.com/www/3/nakweben.nsf/0/6D7C544D5F376866C22581A0006883A0?OpenDocument&year=2017&month=09&nt=News&>

## Chapter 1. Energy sector and SOE landscape

### Background and context

Ukraine is the second largest country in Europe and is strategically located next to Russian Federation (Russia), Central Europe and the Black Sea area, placing it in the centre of oil and gas transit routes between Russia and the European Union (EU). Both its geographic location, its gas reserves, and its historical ties to Russia, under the Soviet Union and following independence in 1991, explain the strategic importance of oil and gas sector and transit routes to the economy of Ukraine.

Ukraine faces considerable economic challenges, and most recently following the 2013-2014 Ukrainian Revolution of Dignity (further referred as Euromaidan revolution)<sup>2</sup> and following the military occupation of the Crimean peninsula by Russia and Russian involvement in and support for armed insurrections in parts of the Donetsk and Luhansk regions of the country. Following these events, relations between the Russia and Ukraine have become extremely tense and have led to (a still unresolved) gas supply dispute between the two countries' national oil companies Naftogaz and Gazprom; severe damage to industrial capacity and infrastructure in the east; and significant disruptions in bilateral trade.

According to OECD (2016a), the economy has suffered (and to a large degree still suffers) from problems relating to Ukraine's unsustainable foreign payments; unsustainable public finances with a high budget deficit - general government gross debt is estimated to be 70,5 per cent of expected GDP in 2018 (IMF, 2018); and sharp macroeconomic adjustments due to depreciation of the currency. Although, the security challenges and political and economic uncertainty have taken a toll on economic indicators, many of the problems facing the economy are of a structural nature having to do with poor business environment, weak institutions and widespread corruption.<sup>3</sup>

Following the change in government in 2014, successive governments have committed themselves, due in part to loan conditionalities, to work on structural reforms with the aim of restoring macroeconomic stability, strengthening economic governance and transparency, and generating sustainable economic growth. Ukraine has signed an Association Agreement (AA), including a Deep and Comprehensive Free Trade Area (DCFTA), with the EU. An International Monetary Fund (IMF) stabilisation programme initiated in 2015 has put forward key structural reform priorities for Ukraine.<sup>4</sup> The EBRD has also launched a package to support reform, which includes energy sector reforms as a key pillar. According to observations of the international community, the pace of reform has varied. Not surprisingly, state-owned enterprise reform has figured at the front and centre of structural reform efforts promoted by the international financial institutions. During this period, the government notably introduced an annual aggregate report for the top 100 SOEs and other reforms aimed at professionalising ownership of SOEs.

In parallel, at the behest of EBRD the government embarked on an ambitious reform agenda aimed at the transformation of the gas sector of Ukraine and to ensure readiness for the



Third Energy Package. A Corporate Governance Action Plan (CGAP) was developed as a tool to support the transformation of Naftogaz, where EBRD took the lead (ensuring the positions of the IMF and World Bank), using the OECD Guidelines for Corporate Governance of SOEs as a benchmark for reform.

As a vertically integrated oil and gas group of companies, the Naftogaz group has extensive operations in the Ukrainian energy sector, and is engaged in the full cycle of operations in gas and oil field exploration and development, production and oil and gas field services, gas and oil transmission and storage, refining, sales and supply of natural gas, LPG and other fuel products to consumers. Moreover, it is an important vehicle through which the State delivers on public policy objectives to supply subsidized gas to households, heat generating utilities and religious organisations. Given its large revenue stream, especially in certain segments of its operations, it has served as a key source of budget revenue for the state both in terms of dividends and tax payments. Due to the ubiquity of Naftogaz in the Ukrainian energy sector, it was expected that many of the recommendations with regard to improvements to its corporate governance can also have wider implications for the sector and plans for gas market liberalisation, with broad reaching effects for the Ukrainian economy.

While implementing the CGAP, the company went through an intense period of a reform. The main lines of the CGAP (Box 1.1.), *inter alia*, were to establish a first-ever independent supervisory board; to delegate the oversight of the company from the government to the independent supervisory board; to cancel mandatory voting instructions to members of the board; to conduct independent external audit; and replacement of statutory controls with a system of internal controls. The overall aim of the plan was to further insulate the company from undue political intervention and reduce corruption risk.

By April 2018, most of elements of the Plan were implemented and the results have been overall positive. The first-ever independent supervisory board (not only for Naftogaz but for any SOE in Ukraine) was put into place in 2016. Despite the successive resignation of a number of board members (independent supervisory board members and one state-representative) due to a long list of reasons (see Box 1.1.), this was no small achievement in transforming the governance mechanisms in the company. The government appointed a new board as of late 2017, and, at the moment of writing this board has remained operational and current reforms aim at further empowering this board to fulfil its mandate.<sup>5</sup> Successful turnaround of the company included turning it profitable (after successive years of being loss-making) in 2016; physical and contractual diversification of supply of imported gas; counteracting Russian side during gas war of 2014 and Stockholm arbitration versus Gazprom; as well overall professionalising management of the group.

During this period, the government centralised ownership of Naftogaz. This started first by shifting the authorities to manage the corporate rights of Naftogaz from the Ministry of Energy and Coal to the Ministry of Economic Development and Trade and ultimately to the Cabinet of Ministers (CMU). The success of the CMU as a professional and informed body can only be tested with time.

Although the initial CGAP was designed exclusively for Naftogaz and included a broader focus than corporate governance reform, parts of it were later used as roadmap by the government to roll out further corporate governance reforms in SOEs. In this process, the government has embarked on an ambitious agenda to roll out similar reforms in the economically most important SOEs of Ukraine, the most visible of which including the progressive nomination of independent supervisory boards to SOEs and enhanced

transparency and disclosure requirements. Starting from 2014, the government has also began publishing an annual aggregate report for the top 100 SOEs.

#### Box 1.1. Naftogaz as a flagship for corporate governance reform

**In 2015 at the initiative of Naftogaz and backed by the EBRD, the government of Ukraine, together with the support of other international financial institutions and donors, undertook an ambitious reform agenda to upgrade SOE practices in line with the OECD Guidelines on Corporate Governance of SOEs. The agenda was aimed at supporting the transformation of Ukraine's gas sector of and ensure readiness for the Third Energy Package.**

Naftogaz has become a flagship company for corporate governance reform. In particular, its reform is being benchmarked according to the SOE Guidelines as per the plan of actions for corporate governance implementation at Naftogaz (further – the Corporate Governance Action Plan or CGAP) developed, together with the EBRD, in view of meeting its loan conditionality.

In 2015, the CGAP was adopted by the Cabinet of Ministers of Ukraine<sup>6</sup>. The CGAP envisaged the elaboration and approval of amendments to laws regulating the governance of SOEs in order to bring it closer to the G20/OECD Principles of Corporate Governance and the SOE Guidelines - this was part of an agreement with EBRD as part of a package that included financing and company transformation.

The first-ever independent Supervisory Board was appointed and became operational in May 2016. Although members of this board (all independent directors and one state representative) ultimately resigned, expressing a number of complaints. According to public records, these included allegations of:<sup>7</sup>

- excessive state intervention in the company's operations;
- government interference in subsidiary companies;
- lack of clarify on commitment of the government to implement the CGAP;
- appointment of officials relieved of duties in Naftogaz to key government positions; and,
- lack of approval of the government of key documents, including the business plans and strategy of the company.

The government since appointed a new board as of end-2017 formed by seven members: three state representatives and four independent members<sup>8</sup>.

Source: CGAP<sup>9</sup> and Naftogaz.<sup>10</sup>

Other important energy reforms also took place during this period, including the enactment of the Natural Gas Market Law which aimed to facilitate the implementation of the EU Directive 2009/73/EU and other EU acquis, deregulate gas prices, introduce transparent public service obligation (PSO) regime and categories of protected consumers, specify TSO unbundling models and certification requirements (to meet commitments made to the EU), while also introducing opportunities for more investment and private participation in the energy sector.

The success of Naftogaz and the development of the hydrocarbons sector more generally in Ukraine hinges not only on its ability to reform, but also to transform itself in a new

geopolitical context. It has many challenges ahead, some of which it can control with reforms on the inside; others which the state as a shareholder can perform better. However, there are a number of geopolitical challenges relating to uncertainties in the future of gas transit routes through Ukraine because of continued Russian economic, military and political pressure. This includes the threat posed by geopolitical alternative gas transit projects, including Nord Stream 2 and Turkish Stream.<sup>11</sup> For Ukraine, gas transit is an important revenue stream equal to 2.5% of GDP. This income ensures that it can mitigate the financial risks, which in turn serves as a safeguard against a future escalation of conflict with Russia. Given its importance, the government considers it necessary to ensure secure transit of natural gas to Europe after 2020 when Naftogaz contract with Gazprom expires.

Therefore, continuing the reform is of utmost importance for Ukraine's national and energy security. However, the process is complicated by a reform environment characterised by very powerful – and sometimes reform-resistant – vested interests (World Bank, 2018). Therefore, despite the important reforms implemented to date, observers criticise that the pace of reforms has slowed and that reform appetite has waned. It is against this background that this OECD review is taking place.

Given the strategic importance of the hydrocarbons sector, the improvement of the functioning of Naftogaz also has implications for the efficiency and competitiveness of the Ukrainian energy sector overall. By bringing the corporate governance of Ukraine's largest energy company in line with international best practices, it will make possible the future integration of Ukraine's economy into the European market, improving Ukrainian economic development, European energy security, and Ukrainian-European integration more broadly.

The rest of this report is structured in three parts. Part I will discuss the overall SOE landscape, covering the reform environment (1.1); the size, sectorial distribution and ownership of SOEs (1.2); and SOE ownership in the hydrocarbon's sector as well as key energy reforms (1.3). Part II of the report is the assessment of SOE reform in the hydrocarbons sector, covering Naftogaz as a case study including an introduction to the company (2.1); an overview of the company's governance (2.2); and state ownership practices (2.3). Part III offers conclusions and recommendations.

### ***Reform environment***

As may be deduced from the previous section, Ukraine's weak past economic performance largely reflects the incomplete transition to a market economy. Businesses and markets remain subject to heavy regulation. According to the IMF (2017), important parts of the economy are dominated by oligarchs and inefficient SOEs, deterring competition and contributing to corruption. Despite some efforts, no large SOE has been privatised in recent years - although a newly passed law on privatisation aims to fast-track the process. (For more on privatisation see section 1.2.5)

The pace of privatisation is further hindered by a lack of viable exit alternatives including through partial privatisations via stock market listings given the underdeveloped capital markets in Ukraine. The system is heavily fragmented and inefficient. There are five licensed stock exchanges, hundreds of commodity exchanges, one central securities depository one settlement centre; and, some of the exchanges offer clearing services for derivatives.<sup>12</sup> (EBRD, 2017). Overregulation has reportedly deterred foreign investment, including in capital markets (partly due to issues related to staving off investment from Russian investors).<sup>13</sup> The National Securities and Stock Market Commission (NSSMC), the securities market regulator, is embarking on a reform to defragment and upgrade capital

markets but this reform is at a very early stage. Moreover a new privatisation law enacted in 2018 is intended to further simplify the privatisation process but it needs to be implemented. Finally, financial market reform is underway, including that of the role of the National Bank of Ukraine as key regulator of the financial sector and in reforming financial markets. In general, corporate governance frameworks are highly underdeveloped in Ukraine, which contributes to some of the challenges in reforming SOE governance, especially for corporatized SOEs. The Company Law is outdated, and although there are some corporate governance principles (approved by the National Securities Commission) the principles are outdated and do not contribute to better comprehension of on how to apply established best practices and principles of corporate governance. Several non-governmental initiatives, including the Ukrainian Corporate Governance Academy, are actively involved in addressing some of these gaps, including through raising awareness of best practices and principles in corporate governance and developing voluntary recommendations.<sup>14</sup>

The reform environment is further complicated by a "temporary" moratorium on agricultural land sales, which has been extended repeatedly over the past few years. It has also proved to be a hindrance to the sale of state property and other SOE assets affected by the land moratorium. In general, private and foreign investments are considered low compared to other countries in the region, limiting potential output.

The political environment is also particularly challenging. This is due to a number of factors, including the on-going violations of Ukraine's territorial integrity and the continuing Russian-backed insurrection in the East. Moreover, the narrow majority in parliament has delayed a number of key reforms and runs the risk of possible policy reversals which face strong pushback from vested interests. The presidential and parliamentary elections which will take off in 2019 will only put more pressure on the current and future government and could potentially further delay reform efforts.

### *Corruption and state capture as a particular challenge for the reform of SOEs*

Some years ago the MEDT (MEDT, 2014) identified mismanagement, vested interests and plain corruption in the SOE sector as underlying causes of continuous losses incurred by SOEs. The government has been gradually trying to tackle these issues through the enactment of a number of anti-corruption measures, the first step being the adoption of a comprehensive anti-corruption package of laws, and a reform of the anti-corruption institutional infrastructure. A number of new specialised agencies were set up.<sup>15</sup> In June 2018 the Ukrainian authorities also adopted a law to set-up a High Anti-Corruption Court (HACC) which has been long awaited addition to the anti-corruption institutional infrastructure.

In parallel a new set of digital tools were put in place to deter and prevent corruption and provide enhanced transparency in a number of susceptible areas as part of an EBRD sponsored project.<sup>16</sup> To enhance transparency around personal finance of public officials, an electronic asset disclosure system was put in place, and to raise transparency and enhance integrity an e-procurement system is now being widely used for public procurement (ProZorro); this follows a more general revision of the public procurement policies enacted in 2016. (OECD, 2017). These important changes however are not yet reflected on actual and perceived levels of corruption in Ukraine, which according to OECD, 2017 remain very high. Anti-corruption enforcement in general and particularly against high-level officials is stalling and meets enormous resistance, and the public trust

has also eroded in recent years. Moreover, the reforms will take time to permeate through the system.

A 2018 OECD review of Ukraine on the prevention and prosecution of corruption in state-owned enterprises (OECD, 2018a) identifies political meddling and capture of SOEs as the overarching theme of corruption related allegations, investigations and prosecutions. Most of these involve schemes where SOEs have a shadow proprietor who exploits opaque procurement or transfer-pricing schemes (Åslund, 2015)<sup>17</sup>: in other words the purchase of goods and services for SOEs at prices which are higher than market prices, and the selling goods or services produced by SOEs at prices lower than market prices to intermediary companies which then resell the goods at market prices. In most cases the corruption often involves kickbacks to related parties, i.e. members of the management of the SOE (management at various levels); officials of the relevant ownership entity; or members of the political elite having control or executing oversight over the relevant sector, industry, ministry or enterprise (OECD, 2018a) (World Bank, 2018). The schemes often involve a network of intermediary firms affiliated with the corruption schemes.

Annual reports by the anti-corruption enforcement agency, NABU, highlight the pervasiveness of corruption schemes in SOEs. Their reports emphasize that the poor oversight of SOEs by responsible state bodies as well as weak governance and management systems are partly to blame. It has opened doors for politicians and public officials to intervene improperly, for the misappropriation of public assets, as well as other forms of corruption to thrive. According to numerous sources, including the current Prime Minister, corruption remains one of the biggest challenges and obstacles to SOE reform.

### *Legal and judicial system*

Ukraine's legal system is also in transition and, as a result there are a number of legal uncertainties and conflicting provisions that have not yet been resolved. With regard to SOEs, this gives rise to some important issues, as there is a plethora of laws, amendments to laws and resolutions; as well as a series of orders, decrees, decisions and other similar governmental regulatory and judicial acts currently in force. The lack of clarity as to who is regulating SOEs, setting policies for SOEs and even exercising ownership can create opportunities for undue political interference or excessive intervention in SOE operations. These legal uncertainties also create confusion regarding the ownership of the assets of SOEs - a key problem discussed in later sections.<sup>18</sup>

More broadly speaking, the problems in the legal system and judiciary relate to:

- inconsistencies between and among the Constitution and various laws, presidential decrees, governmental, ministerial and local orders, decisions, resolutions and other acts;
- provisions in the laws and regulations that are ambiguously worded or lack specificity and thereby raise difficulties when implemented or interpreted;
- difficulty in predicting the outcome of judicial application of Ukrainian legislation due to, amongst other factors, a general inconsistency in the judicial interpretation of such legislation in the same or similar cases;
- as a civil law jurisdiction, judicial decisions under Ukrainian law generally have no precedent effect. For the same reason, courts themselves are generally not bound by earlier decisions taken under the same or similar circumstances, which can result

in the inconsistent application of Ukrainian legislation to resolve the same or similar disputes;

- the fact that not all Ukrainian resolutions, orders, decrees, protocol decisions and similar governmental, regulatory and judicial acts are readily available to the public or available in comprehensibly organised form; and
- the fact that the resolutions, decisions, clarifications and similar governmental, regulatory and judicial acts which by their nature do not have the same effect as primary legislation are capable of being challenged or questioned, including on the grounds that they contravene or contradict relevant primary legislation.

Some observers have also pointed out uncertainties relating to the independence of the judicial system and its immunity from economic and political influences, despite some improvements to the court system and nomination process of judges instilled in 2016.<sup>19</sup>

## Size, sectorial distribution of SOEs in Ukraine

### *Types of SOEs and sectorial distribution*

According to the Ministry of Economic Development and Trade and State Property Fund, there are 3789 SOEs (3554 majority-owned) owned by the Government of Ukraine (counting both the national and regional level).<sup>20</sup> Over half of these are reported to be either inactive or in the process of being liquidated. Government ownership is decentralised with over 85 government ministries and agencies exercising ownership with portfolios of varying size and importance. The exact size and sectorial distribution of the portfolio is unknown due to a lack of systematic organized data collection and reporting by ownership entities. According to estimates by the SPF, the number of active companies it is to represent around 700 enterprises not counting those companies that are in a process of liquidation or disposal.<sup>21</sup> Among the portfolio of entities, there is no clear differentiation among those principally carrying out "economic" activities<sup>22</sup>; versus those entities whose primary purpose is to carry out a public policy function (such as corporatized regulatory agencies). An important caveat is that where information is available, such as through the central registry for government property (held by the State Property Fund), or the list of SOEs compiled by the MEDT, these reports are confirmed by both sources to be incomplete, based on unverifiable information and lack timely update.

**Table 1.1. Size of the SOE Sector**

Year	SOE Net revenue (UAH billion)	Number SOEs	Active SOEs (Percent)	Number employees (in thousands)
2013	279,8	3632	58,1	1112,3
2014	376,9	3338	54,8	930,0
2015	442,7	3458	52,1	849,3
2016	590,8	3435	51,5	847,0
2017 (Q1)	190,2	3421	50,1	820,5

*Note:* Excluding the financial sector.

Source: OECD, 2018.

Despite these reporting shortcomings, a number of observations can be made based on the top 100 majority-owned SOEs, which according to the MEDT, account for roughly 80 percent of total assets and revenue of the entire portfolio. According to the latest available

data reported by MEDT in 2016, SOEs employ over 847 thousand people, the total book value of assets accounts for UAH 1 441 billion and the annual revenue amounted to UAH 591 billion<sup>23</sup> (MEDT, 2016). Excluding the financial sector, the distribution of the portfolio is spread across the electricity, transportation, machine building, coal mining, oil and gas, food and agriculture, chemicals and other sectors, with the oil and gas sector comprising of over half the book asset and equity value, and the transportation sector accounting for over half of SOE employment. The largest SOEs in these sectors are the following:

- oil and gas sector: “Naftogaz” (national oil and gas company) and its subsidiaries;
- transportation sector: “Ukrzaliznytsia” (railway transportation), “Sea port administration” (oversight of sea ports), “Boryspil” Airport;
- energy sector: “Energorynok” (energy market), “Ukrhydroenergo” (hydro power generation), Ukrenergo (electricity); “Energoatom” (nuclear power generation);
- food and agricultural sector: “State Food & Grain Corporation” (grain trading);
- machine building sector: Construction bureau “Pivdenne” (rocket development), “Turboatom” (turbine manufacturing); and,
- chemicals sector: “Odessa Portside Plant” (nitrogen fertilizer production).

The size of the portfolio is very large, reflecting the fact that Ukraine has yet to undergo a large scale privatisation programme to catch up with levels of state ownership observed in other comparable post-transition economies.

These enterprises operate in a number of SOE legal forms, including:

- state unitary enterprise (operating as a state-owned commercial entity or as a budget-supported treasury or "kazenni" entity) being the predominant SOE legal form<sup>24</sup>;
- joint-stock company (JSC) - only 325 companies have this status;
- state-owned business association; and,
- other (e.g. limited liability company (LLC) - only 87 companies have this corporate form).

### ***Ownership model and institutional set-up***

State ownership is fully decentralised in Ukraine, with over 85 different state actors, ranging from the Cabinet of Ministers, and State Property Fund, to line ministries and state agencies exercising ownership rights (see below Table 1.2). As a result, there are multiple actors involved in state ownership; and with such a large portfolio, there is a lack of consistent policy across the government on their ownership and management.

Most of these disparate ownership entities combine multiple roles, including exercising ownership rights, formulating state policy and setting regulation (or if not advocating on behalf of the policy communities that they serve). This often results in a conflict of interest and impaired ability of the ownership entity to manage SOEs effectively and professionally, with a view to enhance their performance and raise accountability. A sample of key challenges highlighted by observers include (Boytsun, 2015, MEDT, 2014):

- state authorities have pursued short-term objectives with SOEs, including using them to maximising fiscal revenues or serve various political or vested interests;

- unclear separation of powers and responsibilities between the shareholding ministry and other government entities provides opportunity for undue political interference or excessive intervention (e.g. SOE answers to multiple and competing requests from different ministries; state does not speak with one voice as shareholder; lack of separation between ownership and regulatory responsibilities);
- lack of clear ownership policy for the overarching state-portfolio for individual SOEs which allows for an incoherent policy towards the sector and multiple and competing objectives for individual entities;
- the commercial interest in SOEs conflicts with the state's social policies and regulatory functions; and,
- intervention by the ownership entity, and other governmental functions, in day-to-day management of SOEs is common place.

The 2006 Law of Ukraine "On the Management of State Assets" (Law 185-V), sets out the overarching legal framework for the exercise of ownership rights in SOEs. It was the first attempt to consolidate the fragmented system of state ownership in Ukraine, and its authors had intended that it empowered the CMU to act as a centralised ownership entity, moving away from the decentralised model of ownership. Alas, the law was not as ambitious as its authors had intended, and centralisation of state ownership lacked political support, but it did introduce the first overarching legislation pertaining to SOEs with the aim of setting out the institutional roles and responsibilities involved in state ownership. The law has since been amended in various iterations, including the 2016 amendment, but still remains the reference law with regard to SOE governance. (Box 1.2)

In practice there are two key institutions that are involved in state ownership from a whole-of-government perspective, this includes the Cabinet of Ministers which is mandated to steer state ownership policy; and the MEDT which is responsible for formulation of state policy and defining general principles and strategic priorities for the management of SOEs. (See table 1.2 for more details on their respective roles.) Both of these entities also exercise shareholder rights in SOEs in their own right, but also have the broader mandate to shape the institutional, legal and policy environment in which SOEs operate.

The State Property Fund also plays an important role seeing through the privatisation of entities approved off the list of companies identified by the Cabinet of Ministers, but as discussed below it has faced challenges of its own. Finally, a team of Reform Support Units that are overseen by a Reform Delivery Office (operated out of the CMU) plays an important advisory role, but lacks the authority and permanence to influence political processes. As demonstrated below, these institutions tend to have sometimes conflicting if not overlapping responsibilities over SOEs. A description of the roles of each of these institutions in the SOE sector is presented below.



### Box 1.2. Roles and responsibilities of state institutions in SOE governance

**The 2006 “Law On Management of State Assets” (Article 16) defines government bodies responsible for monitoring and evaluation, and oversight of SOE performance. The responsibilities are defined as follows:**

- Line ministries and the SPF should submit consolidated financial plans of the SOEs (in their respective portfolios) and information on their implementation to the MEDT.
- The MEDT reviews these documents and in turn, submits to the CMU, a consolidated report together with the proposals to improve SOE operational performance.
- According to the requirements of budgetary legislation, the MEDT submits to the MOF a consolidated financial plan for SOE, highlighting the impact of the SOE performance on the state budget.
- Line ministries are responsible to appoint SOE managers\* and monitor SOEs primarily through the review of in-year reports and through the annual evaluation of performance against the management performance contracts.
- In cases where supervisory boards have been established, line ministries, often in consultation with the CMU, appoint representatives to the Supervisory Board.\*
- The SPF, as the primary government agency responsible for privatisation, is heavily involved in the appointment of company management, appointment of representatives to the board of directors, reviews and approves company financial plans, business strategies and is responsible for the evaluation of company performance for companies under its oversight/ management.
- Control and audit authorities<sup>25</sup> are entitled to audit SOEs to prevent financial violations and such audits are primarily concerned with compliance with budget legislation and other relevant legal acts and are not meant to conform to the principle of an independent (external) financial audit. (IMF, 2017)

Note\*: With recent changes to the board nomination process as noted in section 2, the line ministries are no longer responsible for CEO and Board nomination in economically significant SOEs. Rather their nomination is made by an inter-governmental committee and subject to further professionalization of the process.

Source: Law 185-V and IMF, 2017.

**Table 1.2. State ownership in Ukraine: institutional framework**

A number of key institutions are involved in setting overall state ownership policy, in monitoring performance and in exercising state ownership rights.

Institution	Role/Responsibilities with regard to SOEs
Cabinet of Ministers - Cabinet of Ministers of Ukraine is the highest executive authority, collegial body chaired by the Prime Minister and is accountable before and reporting to the Parliament	<ul style="list-style-type: none"> <li>• Assigns responsibility for governance of state-owned assets to executive authorities and collective public bodies;</li> <li>• Regulates the procedure for assignment of state-owned assets to supervisory authorities;</li> <li>• Exercises decision-making authority in respect of establishment, reorganisation and liquidation of entities and assigns responsibility for control over their operations to relevant supervisory bodies;</li> <li>• Sets performance criteria for management of state-owned assets and the process for application of these criteria;</li> <li>• Approves the list of state-owned assets that are strategically important for the national economy and security; defines non-economic or public policy objectives accordingly.</li> <li>• Responsible for nomination committee for selection of CEOs of SOEs, competitive selection of independent SB members of SOEs, and appointment and approval of representatives of the state in the SBs of SOEs.</li> <li>• Enacts the dividend policy set by Ministry of Finance and MEDT</li> </ul>
Ministry of Economic Development and Trade (MEDT) - responsible for formulation and implementation of the state economic policy	<ul style="list-style-type: none"> <li>• Is responsible for formulation of the state policy and definition of general principles and strategic priorities for the management of state-owned assets, including corporate rights held by the State;</li> <li>• Sets performance criteria for management of the corporate rights of the state;</li> <li>• Formally responsible for formulation of state dividend policy in consultation with Ministry of Finance;</li> <li>• Control the authorities responsible for the management of corporate rights of the State and monitor the performance of state-owned assets under their oversight;</li> <li>• Identifies the state-owned assets that are not subject to privatisation (at the suggestion of authorities responsible for management of corporate rights of the state).</li> </ul>
Ministry of Finance - financial and fiscal oversight of SOEs	<ul style="list-style-type: none"> <li>• Together with the MEDT, is responsible for formulation and implementation of the state dividend policy;</li> <li>• Monitors the fiscal impact of state assets, and deploys State Financial Inspection to audit SOEs</li> <li>• Approves subsidies in sectors for which line Ministries manage and oversee SOEs.</li> </ul>
Ministries, other executive authorities, and national collective bodies with regard to the SOEs where authorized to manage corporate rights of the State	<ul style="list-style-type: none"> <li>• Exercise decision-making authority in respect of establishment, reorganisation and liquidation of SOEs under oversight;</li> <li>• Initiate the establishment of business entities, develop draft statutory documents, approve statutes (articles of association) for SOEs within the scope of their authority;</li> <li>• Appoint and dismiss executives of SOEs;</li> <li>• Approve annual financial and investment plans;</li> <li>• Organise annual audits;</li> <li>• Implement controls over state-owned properties under their purview.</li> </ul>
State Property Fund of Ukraine	<ul style="list-style-type: none"> <li>• Acts as the main privatisation authority</li> <li>• Acts as a lessor of integral property complexes of SOEs;</li> <li>• On behalf of the State, acts as a founding participant of business entities and contributes state-owned property to their share capitals;</li> <li>• Within the scope defined by legislation, is responsible for establishment and maintenance of the Unified Register of State-Owned Property;</li> <li>• When required by law, manages disposal of real estate owned by unitary SOEs</li> <li>• Exercises right to establish, manage and liquidate SOEs.</li> </ul>
Other governance bodies	<ul style="list-style-type: none"> <li>• Authorities that support the President of Ukraine, the Ukrainian Parliament and the Cabinet of Ministers of Ukraine;</li> <li>• Bodies managing the state-owned property within the authority determined in individual laws; state-owned business associations, state-owned holding companies, and other state-owned business organisations;</li> </ul>
Reform support units and Reform delivery office	<ul style="list-style-type: none"> <li>• Support and advise formulation of reform. Monitor implementation within line Ministries.</li> </ul>

*Source:* Adapted from MEDT, 2014 and questionnaire responses provided by Ukrainian authorities.

### *Cabinet of Ministers and its Secretariat*

The CMU has the power to assign responsibility over state-owned enterprises to line ministries and other public authorities. It approves the list of strategically important SOEs and also has powers to decide on establishment, reorganisation and liquidation of SOEs and assign institutions responsible for these processes. Additionally, it sets performance criteria for the management of SOEs. It also issues regulations on processes which relate to governance of the SOEs, as well as various resolutions in regards to broader strategic issues. Most recently, it has also been entrusted with overseeing the nomination committee for the selection of supervisory board members and CEOs in strategically important SOEs.

As of 2016 the Cabinet of Ministers was assigned as the ownership entity of Naftogaz (i.e. it took over the authority to manage corporate rights of the State from MEDT) extending its portfolio of companies to 12 entities. The addition of Naftogaz represents a significant enlargement of responsibility considering that it is the largest SOE operating in Ukraine, and is the key player in the hydrocarbons sector, is of particular strategic importance.

Until now the Cabinet of Ministers has not demonstrated ability to ensure an effective system for the oversight of Naftogaz and other SOEs. This is largely due to the absence of a dedicated unit which is adequately funded, professionally staffed nor at arms-length with policy-making within the CMU to be in charge of the SOE portfolio. The CMU itself is a political cabinet which includes ministers and politicians. According to the Charter of Naftogaz, the ownership entity for Naftogaz lies in the Cabinet of Ministers of Ukraine.<sup>26</sup> No indication was provided on the team responsible for carrying out shareholder duties. One of the main issues is that CMU continues to be responsible for broad policy making while also acting as the owner of strategically important SOEs, making its role rather conflicted. This can be most visible in the case of Naftogaz and the energy sector for which it sets public policy objectives as well. These roles are not separated at arm's length as is recommended by best practice.

Although the CMU is supported by a Secretariat (SCMU), it does not support the CMU in the fulfilment of its duties and responsibilities as ownership entity of Naftogaz. The SCMU is working towards transforming its role into a stronger “centre of government including in the management of important and significant SOEs.”

### *Ministry of Economic Development and Trade*

The MEDT is the authority responsible for the formulation and implementation of the state economic policy, including the definition of general principles and strategic priorities for the administration of state-owned assets. It sets performance criteria for the management of SOEs by ownership entities, as well as individual SOE performance. Together with the Ministry of Finance, it is responsible for the formulation and implementation of the State dividend policy. Additionally, MEDT is responsible for identifying the list of state-owned enterprises that are considered strategic which is then submitted to the CMU for approval. With regard to Naftogaz, MEDT is responsible for all corporate decision-making of the CMU as the body authorized to manage corporate rights of the State, which includes drafting of these decisions and having them approved by the relevant ministries.

According to OECD (2018), MEDT appears to be struggling with its broad functions. Since 2013, the ministry has been re-organised 8 times and since 2014 there have been 5 ministers in place. The responsibility for the development of a state ownership policy has been reassigned within the organisation three times since November 2015. According to the Accounting Chamber’s 2017 state-audit report of the SOE sector, the ministry’s whole-of-

government policy and performance monitoring role of SOEs is underfunded: on average the responsible units receive approximately 55 percent of the funding that they request to carry out their role (OECD, 2018a).<sup>27</sup>

Management of the SOEs where MEDT exercises ownership rights has also been considered ineffective. In 2016, out of 335 SOEs under its direct supervision only 81 (less than 25%) were deemed profitable, and four SOEs were unaccounted for due to lack of information.

The MEDT has been criticized for a lack of strategic vision with regard to the state portfolio. The MEDT arguably lacks the competence and ability to meaningfully evaluate performance of the overall state portfolio in view of developing an overall ownership policy. Since 2014, the MEDT, with the support of the Reform Support Team, annually publishes an aggregate report on state ownership of the top-100 economically important SOEs. The report is issued annually and is published on the website of the ministry, latest editions available only in Ukrainian language. The report has key financial data on the performance of individual SOEs and key sectors of the economy. While it remains a key reference, the quality and veracity of the financial and non-financial information has been contested.

### *State Property Fund of Ukraine*

The SPF is essentially Ukraine's privatisation agency, but it also oversees and manages other state assets. It currently exercises direct ownership on behalf of the State in over 300 SOEs, which have been earmarked for privatisation. Among the list of 26 approved large SOEs (May 2018), the SPF exercises its ownership rights in over two thirds of them.<sup>28</sup> When state assets are transferred to the SPF it is responsible for their restructuring with the purpose of making the assets more attractive to potential buyers. To this end it works on establishing governance bodies (in case there are none), financial planning, accounting, reporting etc. The SPF appoints its employees as chairs or members of supervisory boards of these enterprises representing the SPF as the sole or main shareholder. Additionally, the SPF is responsible for the establishment and maintenance of the Unified Register of State-Owned Property, which only holds information on a select number of SOEs in the state portfolio.

The SPF does not have an impressive track record when it comes to seeing through privatisations, as discussed earlier in the report. This is reportedly due to being under-resourced in activities related to the pre-privatisation process (OECD, 2018a). The SPF lacks in-house skills and competence to see through the process, despite having an arguably large number of personnel employing over 460 persons in its headquarters – with only 80 focused on SOE management - and 1194 persons in its regional offices. Its sheer size contrasts starkly with other institutions responsible for large portfolios of SOEs.

### *Reform Delivery and Support Units*

Whole-of-government reforms are facilitated by a wider reform architecture, financially supported by international financial institutions and donor support, mainly driven by the EBRD. The system comprises of the National Reform Council of Ukraine, the Reforms Delivery Office (RDO) within the CMU, a network of Reform Support Units (RST) within line Ministries, and the Strategic Advisory Group for Supporting Ukrainian Reforms (SAGSUR). These *de facto* non-governmental support groups, and notably the SAGSUR, play an important role in advising policy makers and even shaping policies with regard to SOEs. For example, the establishment of the board nomination committee, the 2018

Privatisation Law No. 2269-VIII and Draft Law “On amendments to certain legislative acts of Ukraine on improvement of corporate governance of the legal entities whose shareholder (founder, participant) is the state” (hereinafter also – Draft Law 6428, see Box 2.2) emerged from the work of these reform groups, in consultation with the MEDT, the CMU, the State Property Fund and other stakeholders. Despite these important achievements, the Reforms Delivery Office is a consultative and advisory body, without being integrated into the fabric of existing institutions. Its dependence on IFIs and donor financing also means that it is vulnerable to change.

### *Structure and Ownership of the hydrocarbons sector in Ukraine*

Ownership of SOEs operating in the hydrocarbons sector is spread among a few key institutions in Ukraine (see also Table 1.3 and overview below) that fulfil multiple and competing roles, including exercising state ownership rights in key SOEs operating in the sector; setting sectorial policies and strategies; as well as being responsible for regulating the sector, including in the area of licensing. The Naftogaz Group is the key player in many value chain segments. In 2017, it represented 80% of the domestic natural gas production volume (together with the volume of Ukrnafta). It operates Ukraine’s natural gas and oil transmission system and storages.

The private sector is mostly represented by:

- more than 40 gas and oil producers;
- over 60 gas importers, which since 2014, due to the market liberalisation and start of EU gas imports, this segment of gas imports / trading has witnessed significant increase in private participation, both from domestic and international players;
- over 300 private wholesale gas suppliers, retail natural gas supply companies and distribution system operators (the latter of which are mainly controlled by notorious oligarchs);
- Ukratnafta refinery; and
- multiple gas stations.

**Table 1.3. SOEs in the hydrocarbons sector**

Ownership entity	SOE	Description
Cabinet of Ministers	Naftogaz;	Vertically integrated full cycle of operations in gas and oil field exploration and development, production and oil and gas field services, gas and oil transportation and storage, refining, supply of natural gas, LPG and other fuel products to consumers
Ministry of Energy and Coal Industry	Main Gas Pipelines of Ukraine (MGU)	Future gas transmission operator
Ministry of Ecology and Natural Resources - SGSS	Nadra Ukrayiny plus 9 State enterprises	- Oil and gas exploration - Geological and geophysical mapping, research and other data collection; services; laboratories, drilling, airborne geophysical investigations; legislation and licensing; databases and digital communication; and consulting

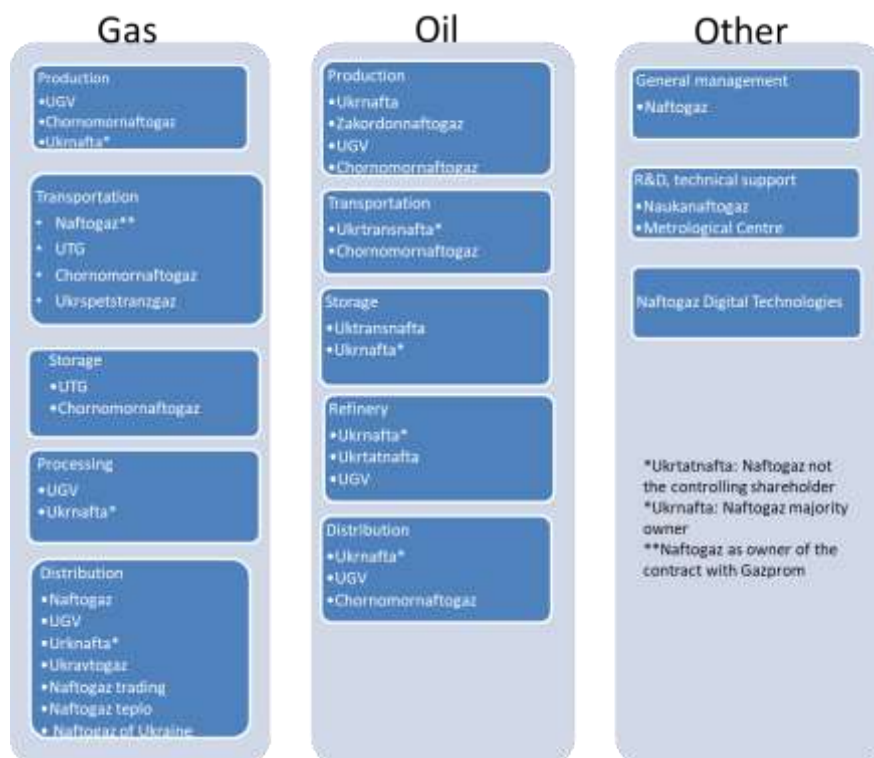
Source: Author.

### *Naftogaz Group - National incumbent oil and gas company of Ukraine*

The State is the shareholder of the Naftogaz and is represented by the Cabinet of Ministers (as introduced earlier) which is the national incumbent oil and gas company of Ukraine. This holding<sup>29</sup> company as well as its subsidiary and daughter companies will be covered in detail under section 2 as the "case study" company for this sector. It should be noted, however, that Naftogaz currently owns both Ukrgezvydobuvannya (UGV), the main producer of natural gas in Ukraine, as well as Ukrtransgaz (UTG), the gas transportation and storage operator in Ukraine; with gas transmission being subject to unbundling as per the Third Energy Package. An overview of Naftogaz's role in the hydrocarbon value chain is provided in Figure 1.1.

**Figure 1.1. Naftogaz and its subsidiaries operating in the oil and gas supply chain**

Naftogaz is involved in the full cycle of operations in gas and oil field exploration and development, production and oil and gas field services, gas and oil transportation and storage, refining, supply of natural gas, LPG and other fuel products to consumers.



Source: Reproduced from Ministry of Economic Development and Trade and Naftogaz.

### *Main Gas Pipelines of Ukraine (MGU) – Gas transmission operator*

The Ministry of Energy and Coal is shareholder of the joint-stock company Main Gas Pipelines of Ukraine (MGU). According to the Roadmap for unbundling (Decision 496), adopted in 2016, the MGU will be Ukraine's future gas transmission operator and the establishment of MGU is part of preparatory measures undertaken by the ministry to carry out unbundling. The actual transfer of assets, property, licences and certifications necessary from UTG - currently under Naftogaz's ownership - has not yet happened and will be subject to a separate resolution from the government. According to the latest information

available at the time of writing, the unbundling process is set to be finalized at the beginning of 2020, after the existing transit contract with Gazprom expires and is currently subject to an MOU established between the supervisory boards of Naftogaz and MGU (for more see section 1.3.2)

For the time being, MGU's governance architecture has been established by the Ministry of Energy and Coal Industry. . Notably, the independent and government appointees to MGU's supervisory board were selected through the centralised nomination committee and subject to a competitive recruitment process, established under the CMU.<sup>30</sup>

#### *State Geological and Subsurface Service of Ukraine (SGSS) – Oil and gas geological mapping, research, licensing and more*

The State Geological and Subsurface Service (SGSS) owns ten SOEs (incorporated mainly as state enterprises, or state "organisations"), operating under its oversight. These SOEs do a range of commercial and non-commercial activities including: geological and geophysical mapping, research and other data collection; services; laboratories, drilling, airborne geophysical investigations; legislation and licensing; databases and digital communication; and consulting. A number of the SOEs operating under the SGSS's oversight also use the oil and gas exploration licences the SGSS exclusively issues, to carry out their own activities which results in a potential conflict of interest.

#### *Nadra Ukrayiny – Oil and gas exploration*

Oil and gas exploration activities are performed by the state company NJSC Nadra Ukrayiny which was established in 2000 by merging a number geological and specialised mining exploration enterprises, which today are separated into 11 different business units under the joint stock holding company officially under the oversight of the SGSS (IEA, 2012, EGS, 2016). These companies hold a lot of geological information related to mining exploration in Ukraine. It should be mentioned that Nadra Ukrayiny owns shares in a network of fully and partly state-owned subsidiary and daughter companies.

**Figure 1.2. Oil and Gas exploration state-owned companies fall under the ownership of the licencing body the SGSS**

The SGSS falls loosely under the Ministry of Ecology and Natural Resources, and owns one state-owned joint stock holding company, Nadra Ukrayiny and 9 state unitary and regional enterprises operating in oil and gas exploration.

State Geological and sub-surface service	State enterprises*	Ukrainian geological company
		Geolcontrol
		Donetskgeologiya
		Pivdenukrgeologiya
		Ukrgefizvka
		Kirovgeologiya
		Skhid
		Prychernomor
		Burshtyn Ukrainy
		Geoinform
	Nadra Ukrayny	UkrNaukaGeoTsentr
		Agrogeophysica
		Chernigivnaftogazgeologiya
		Gorlivrozvidka
		Krimgeologia
		Mirorodnaftogazgeologiya
		Poltavnaftogazgeologia
		Tsentrukgeologia
		Ukrzelbudoroekt
Zahidukrgeologia		
Zhitomirburrozvidka		

*Note:* This list was compiled based on publicly available information.

*Source:* Adapted from ESG, 2016

### *Private participation in the hydrocarbons sector*

Although SOEs have dominated the energy sector in Ukraine, private ownership and control in the sector mainly emerged out of a series of privatisations and consolidations that occurred in the late 1990s in oil processing/refining, and in oil and gas distribution (Stelmakh, 2016). This enabled the partial privatisation of some large companies, for example Ukrnafta as well as the regional gas distribution companies, which were eventually absorbed by Naftogaz. It is well documented that the partial privatisation of SOEs in this sector have been captured by private vested interests, both in earlier phases of privatisation and more recent experiences.<sup>31</sup>

For example, in 2012 the government of Ukraine introduced additional private control of regional gas enterprises (*oblgases*), responsible for distribution of gas.<sup>32</sup> Although this privatisation process was depicted as liberalising the gas market, it created an opportunity for vested interest to gain further control of gas distribution networks. These were sold via auction and the main beneficiary was the joint-stock company ‘Gaztek’ and associated entities controlled by known oligarchs (Stelmakh, 2016).

With the introduction in 2015 of the Natural Gas Market Law and unbundling plans, the legislation attempted to separate the established monopolies in gas supply and distribution. While the formal separation of supply and distribution activities took place and is now performed by *oblgazzbut* companies and *oblgaz* companies respectively, ultimate beneficial ownership of both gas supply and distribution companies was not affected and both groups of companies are still controlled by the same business conglomerates owned by well-known oligarchs. In some cases, these companies are held offshore.<sup>33</sup> (see Figure 1.3)



As discussed earlier, in the upstream gas market there has been a more significant opening in recent years as per the gas market reforms with a rise in the number of independent gas importers.

**Figure 1.3. Control and ownership in the downstream natural gas supply chain, in the so called “last mile”**

Ownership structure and control of “last mile” participants

<b>Naftogaz of Ukraine</b>	<ul style="list-style-type: none"> <li>• 100% owned by the state in the face of the Cabinet of Ministers of Ukraine</li> </ul>
<b>Ukrigasvydobuvannya (UGV)</b>	<ul style="list-style-type: none"> <li>• 100% owned subsidiary of Naftogaz of Ukraine</li> </ul>
<b>Ukrtransgaz (UTC)</b>	<ul style="list-style-type: none"> <li>• 100% owned subsidiary of Naftogaz of Ukraine</li> </ul>
<b>Distribution system operators (DSOs)</b>	<ul style="list-style-type: none"> <li>• Most of distribution system operators are owned and controlled by notorious oligarchs through Regional Gas Companies or through other entities.</li> <li>• Naftogaz controls only one DSO Kirovogradgaz with 51% stake (control regained from July 2018)</li> <li>• Naftogaz' stake of 25%+1 share in many DSOs gives it zero influence over them</li> </ul>
<b>Regional supply companies (RSC)</b>	<ul style="list-style-type: none"> <li>• Most of regional supply companies are controlled by notorious oligarchs, they operate as de facto subsidiaries of DSOs, created after separation of supply and distribution functions in 2015</li> <li>• Naftogaz has recently created its own supply company which has nominal presence</li> </ul>
<b>Municipal heating enterprises (MHEs)</b>	<ul style="list-style-type: none"> <li>• Heating enterprises («TKE») are municipally owned companies (mostly) or private, but most of them operate municipally owned assets</li> <li>• Combined heat and power plants («TELL») are private and state-owned companies</li> </ul>

Source: Naftogaz, 2018.

### *Institutions involved in energy policies, reform, and regulations*

A number of institutions are involved in setting policies, reform priorities and regulating the energy market, and these are often carried out in conjunction with exercising actual ownership rights in SOEs. An overview of individual institutions and their respective roles is provided below and summarised in table 1.4.

### *Setting of public service obligation*

Following the enactment of the 2015 Natural Gas Market Law (as described below), the CMU became the main body responsible for setting the public service obligation for the gas market. As mentioned the CMU also exercises ownership rights over SOEs carrying out public service obligations (PSOs) in the gas sector.

**Table 1.4. Institutions involved in energy policy, ownership and regulation**

Government bodies are often involved in setting policies, regulations and ownership at the same time.

	Description	Policy	Regulation	Ownership
Cabinet of Ministers	<ul style="list-style-type: none"> <li>Setting public service obligation for the gas market</li> <li>Shareholder of Naftogaz</li> <li>Responsible for overall Energy Strategy</li> </ul>	✓	✓	✓
Ministry of Energy and Coal Industry	<ul style="list-style-type: none"> <li>Energy strategy</li> <li>Shareholder of key non hydrocarbon energy companies</li> </ul>	✓	✓	✓
National Commission for State Regulation in the Energy Sector and Utilities	<ul style="list-style-type: none"> <li>Regulates activities of natural monopolies and suppliers in natural gas, coal, oil, fuel products, heat, water and electricity markets</li> <li>Regulates activities in pipeline transmission and storage of natural gas, oil, oil products etc.</li> <li>Sets tariffs for heat and electricity</li> <li>Issues and revokes licensing for heat and electricity sectors</li> </ul>	✗	✓	✗
Ministry of Ecology and Natural Resources - State Geological and Subsurface Service	<ul style="list-style-type: none"> <li>Issues and revokes licensing of all natural resources in Ukraine at national and regional levels</li> <li>Shareholder of Nadra Ukrainy and 9 state and regional enterprises operating in oil and gas exploration</li> <li>Conducts traditional geological survey functions</li> <li>Defining the geological and mining policy of Ukraine and of executing it</li> <li>Collection of fees for exploration and exploration royalties</li> </ul>	✓	✓	✓

Source: Author compiled from various sources.

### *Energy sector policy*

The Ministry of Energy and Coal Industry is notionally responsible for setting the overall energy strategy of the government, although the strategy is ultimately approved by the CMU. The ministry has some responsibility for hydrocarbons production planning, although some of the data and research related to coal, oil and gas are carried out under the State Geological and Subsurface Service of the Ministry of Ecology and Natural Resource (see below). The Ministry of Energy and Coal Industry is also the owner of a number of key SOEs operating in the energy sphere, notably MGU which is going to be the future transmission system operator (TSO) once unbundling plans are seen through. Given commitments under the Energy Community, the ownership and placement of MGU could be subject to discussion given that entities engaged in production (generation) of natural gas and/or electricity should be separated from transmission.

### *Energy sector regulation*

The National Commission for the State Regulation in the Energy and Utilities (NCSREPU) is the regulatory authority with oversight for the energy and utilities sectors.<sup>34</sup> It is also the main licensing and tariff setting body for producers and suppliers of electricity and heat. In the electricity sector the NCSREPU sets retail tariffs for all consumers (including household prices) based on projected electricity prices for the *oblenergos*<sup>35</sup> and independent electricity suppliers. According to a recently adopted law it is also intended to regulate activities in production, transportation, distribution, supply of electricity; activities in transportation, distribution, storage (injection, extraction), providing services in installation

and supply of natural gas, and; activities in pipeline transportation of oil, oil products and other substances. It should be noted that the NCSREPU does not set tariffs for the gas sector, as according to the Natural Gas Market Law tariffs should reflect market pricing. However, the CMU has been using transitory measures to regulate the price of gas to certain segments of the population which Naftogaz is required to fulfil as part of its public service obligation. It is unclear to which extent the CMU draws on the NCSREPU to determine the applicable tariffs for regulated segments of the gas market. It should be noted that a recent evaluation of the Commission undertaken by the Energy Community Secretariat underlines shortcomings with the governance and independence of the regulator. (EC, 2018)

### **Box 1.3. Energy Tariffs and the Regulated Segments of the Gas Market**

Before 2015, natural gas prices were regulated for all consumers in Ukraine, as the state covered the difference between market and regulated prices of Naftogaz's sales volumes. However, Naftogaz incurred losses given an indirect compensation mechanism that regulated prices through intermediaries and gas imports that fulfilled supply gaps. In recent years, the Ukrainian government has taken steps to gradually increase gas prices and liberalise the wholesale and retail markets for consumers in the industrial sector. However, further increases in regulated markets, including households, religious organisations, and district heating companies, have been delayed.

Postponing gas price increases and other reforms have kept Ukraine from fulfilling its obligations to the IMF and the EU. As the IMF stabilisation programme proposed bringing energy prices closer to market levels to meet loan conditionality, the bailout has been suspended. In addition, Ukraine signed the Association Agreement, as well as Deep and Comprehensive Free Trade Agreement with the EU, committing the country to enhanced energy cooperation and market integration, as well as to promoting market-based gas pricing. However, in a recent case opened by the EU Energy Community, the EU Secretariat labelled regulated pricing based on Naftogaz's public service obligation as "illegal State aid." (ECS-2/17, July 2018).

Further to this, the Energy Community has noted that recent legislation aimed at revising the public service obligation regime goes contrary to Ukraine's energy commitments to the EU, and furthermore lay the basis for "disproportionate and discriminatory market conduct of incumbents, and consequently risk leading to further market concentration."

Sources: OECD (2018) Access to Private Finance for Green Investments Energy Efficiency and Renewable Energy Financing in Ukraine). ECS-2/17, July 2018; and letter from Energy Community Secretariat letter, dated 7 November 2018.

### *Licensing for oil and gas exploration*

The State Geological and Subsurface Service of Ukraine (SGSS)<sup>36</sup> is in charge both of defining the geological and mining policy of Ukraine and of executing it. It is the sole entity in Ukraine that issues and revokes licensing of all natural resources in Ukraine; it operates through a network of authorities at national and regional levels. It also collects the fees from licensing and royalties from exploration; while responsible for the more "traditional" roles of a geological survey function. It should be mentioned that the SGSS also owns SOEs (discussed further in section 2.1.5), which given its licensing role, as well as its traditional geological survey role, represents a potential conflict of interest. (ESG, 2016) Some observers have viewed the recent attempt by SGSS to revoke the license of Naftogaz subsidiary UGV on the basis of a technical requirement to be one example of such conflict of interest. (See Box 1.4) Further allegations have been made about corruption

schemes involved in the acquisition of licensing. The recently launched digital register of geological information and the system of competitive e-bidding are a welcome development, which the aims to make the awarding of licenses more transparent.

**Box 1.4. Case study: Gas and oil exploration licensing and Naftogaz subsidiary UGV**

The SGSS has delayed the decision on prolongation of 39 of UGV's licenses to carry out gas exploration, leading to risks of disruption of UGV production. The delay relates to a technical requirement for an environmental impact assessment to be done by oil and gas producers which came into force in December 2017. The actual procedures for this new requirement were formalized by the government in the months following the enactment of the law, for which the final requirements were published as late as June 2018.

UGV requested its licenses to be prolonged in 2017, prior to the enactment of the said law the SGSS. However, the decision to prolong its licenses were delayed on grounds that UGV was non-compliant with the new laws. As a result of the non-renewal of its licenses, on 30 May 2018 UGV was forced to shut down its production in one of its small fields (Pivdenno-Kolomatske).

Ultimately, the government issued a Resolution in June 2018 which allowed for a grace period for oil and gas producers. On 23 July 2018, the SGSS finally prolonged the 39 licenses of UGV.<sup>37</sup>

*Source:* Naftogaz questionnaire response.

***Privatisation policies and recent plans***

Privatisation in Ukraine began in 1995 and picked up pace in the early 2000s but with modest results. Privatisation receipts amounted to 3 per cent of GDP in 2000 compared to an average of 9 per cent in other transition economies for the same period (IMF, 2002). Historically, the pace of privatisation in Ukraine has been very slow due to a number of factors, including restrictions on foreign investments in the privatisation of state and municipal property (if the foreign state owns 25 per cent or more equity) dating from a now out-dated 1992 privatisation law.<sup>38</sup> Other challenges include immature capital markets; political interference in the privatisation process; conflicting objectives of the State Property Fund; and more generally difficult business conditions and complicated company cases that have proven difficult to sell. Even before the sharp economic contraction following the Euromaidan revolution, the privatisation programme had virtually stalled with privatisation receipts representing less than 0.2 percent of GDP in 2013 (IMF, 2016).

Following the Euromaidan Revolution, the government had plans to reinvigorate the privatisation process. It started with changing its investment regime to allow for additional protections of investors rights and opened up more sectors of its economy, previously protected under national security, to foreign investment (OECD, 2016). At the same time, it strengthened public scrutiny over individual transactions to avoid pitfalls of past-privatisations where assets fell into the hands of well-connected oligarchs and vested business interested. (Atlantic Council, 2018) In 2014, the Cabinet of Ministers (CMU Ordinance 667) in cooperation with the State Property Fund developed and approved a list of 160 companies that it planned to privatise, which at the time was hailed as "the largest privatisation campaign in 20 years."<sup>39</sup> A number of large companies were on that list,

including energy generation and distribution companies and a large fertilizers producer, the Odessa Portside Plant.

Owing to an unsuccessful attempt to relaunch the privatisation process, including the failed privatisation of the Odessa Portside Plant, the government changed its approach.<sup>40</sup> Instead of focusing only on the large companies it deems worthy of a privatisation, it has conducted a so-called "triage" exercise dividing SOEs into three categories: those to be privatised, liquidated, or retained.

In order to see through its plans, the Government recently adopted a long-awaited privatisation law, "On Privatisation of State-Owned and Municipal Property" No. 2269-VIII (18 January 2018), which is intended to facilitate both large-scale and small-scale privatisation transactions at the state and municipal levels; enhance the transparency and integrity of individual transactions; and provide for additional guarantees for investors.<sup>41</sup> Many international financial institutions view the passage of this law as a critical step in facilitating a new phase of privatisation in Ukraine.

In May 2018, the CMU approved an updated list of 23 enterprises, including regional power distributors (*Oblenergos*), Centerenergo (for which a detailed sales time line has already been approved), Odessa Portside Plant, Turboatom, Zaporozhye Titanium & Magnesium Works, United Mining and Chemical Company (PJSC UMCC) and PJSC Sumykhimprom. Of the list, 18 facilities are already managed by the State Property Fund of Ukraine<sup>42</sup> as the main body responsible for seeing through privatisation in Ukraine. The SPF has selected and signed contracts for advisory services for an additional six large SOEs which are slated for privatisation. A Privatisation Working Group has been established which brings together IMF, IFC, EBRD and provide recommendations to the Cabinet on future privatisation transactions.

In addition a number of small privatisations have been realised, including, according to governmental sources, 100 successful electronic auctions that were carried out subsequent to the passage of the Privatisation Law.

However, many challenges remain for the pace of privatisation is to match Ukraine's needs both for revenues resulting from sales; and for a drastic reduction in the number of state assets under its portfolio. These challenges include attracting international investors given the current business climate and shedding the influence of vested interests in SOEs; but challenges related to professionalization of the privatisation function. The pace of privatisation is also likely to be affected by the 2019 electoral cycle, as some observers posit that there might not be adequate political will to privatise before elections. To further aggravate the situation, some individual SOEs (Odessa Portside Plant and Sumykhimprom) slated for privatisation in 2018 have a host of issues associated with their debts to well-known oligarchs under international sanctions.<sup>43</sup> According to the international community, these debts are "deal breakers" for privatisation (also for additional risks of transferring payments to a sanctioned entity) and cannot be treated as "ordinary debts".<sup>44</sup>

Although some observers would posit that Naftogaz and other parts of the hydrocarbons sector are not considered for privatisation in the immediate future, the current management has an ambition "to prepare Naftogaz for a public offering within the next several years." (Naftogaz Annual Report, 2017). Ultimately, the final decision will lie with the CMU and the Parliament.<sup>45</sup>

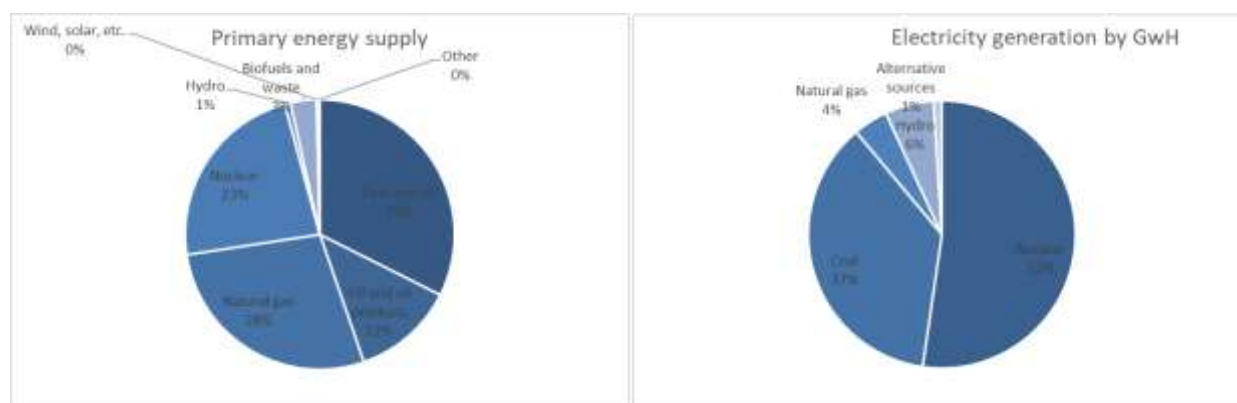
## Hydrocarbon sector and energy sector reform in Ukraine

### *Introduction to the energy sector*

According to recent analysis of Ukraine's energy sector, oil and gas makes up approximately 40 per cent of the country's primary energy supply (Figure 1.3). While oil and gas account for a small proportion of overall electricity production, natural gas remains the main fuel for heat generation (70 percent), which is distributed to approximately 53 per cent of households (directly or indirectly) through a network of district heating plants. (National Investment Council, 2017, OECD, 2018, Naftogaz)

**Figure 1.4. Ukraine's energy supply (2016)**

A majority of Ukraine's primary energy supply is made up of oil and gas, while nuclear and coal power dominates electricity generation.



Source: OECD, 2018 and further updates provided by Naftogaz.

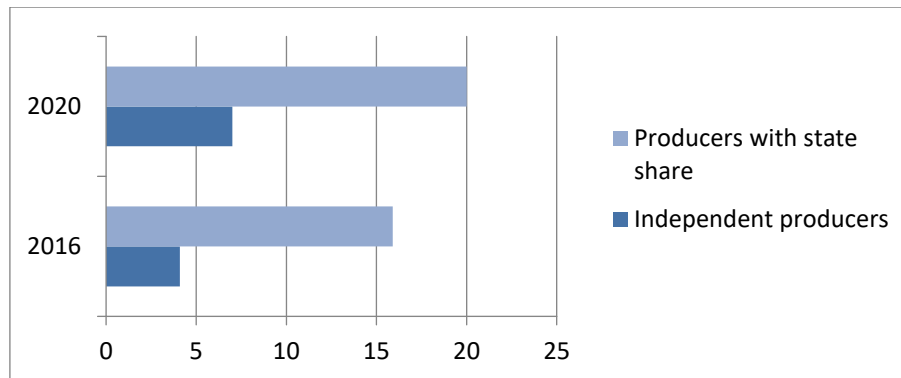
Ukraine is a net importer of energy, in all sources of fuel including oil, gas and coal.<sup>46</sup> In the areas of natural gas and oil, Ukraine secures a large proportion of its domestic needs through its own production. Due to the sectorial focus of this review the remainder of this section will focus mainly on hydrocarbons sector with a particular focus on natural gas.

### *Natural gas and oil production in Ukraine*

Over 70 per cent of gas consumption is covered by local production with a lion's share produced by the Naftogaz subsidiary UGV (OECD, 2018b, NIC, 2017). Natural gas production in Ukraine accounts for approximately 20.5 bcm, with 16.4 bcm produced by state-owned/controlled producers such as UGV, Ukrnafta, and Chronomornaftogaz, and the remaining 4.1 bcm by independent producers.<sup>47</sup> In 2017, UGV grew its production by 4.4% from 14.6 bcm to 15.3 bcm, which was the highest level in 24 years. However, Ukrnafta and private sector companies reduced their production volumes from 1.3 bcm and 4.2 bcm to 1.1 bcm and 4.1 bcm respectively. The government declared plans, as part of its broader Energy Strategy and policies (see below), to increase domestic gas output to 20 bcm in 2020 with increased production by relevant state-owned enterprises as well as by independent producers (Figure 1.5)<sup>5</sup>

**Figure 1.5. Natural gas production in Ukraine, in billion cubic meters (bcm)**

Ukraine plans to up domestic natural gas output to 27 bcm, from its current 20 bcm



Source: National investment Council, 2017 derived from Association of Gas producers of Ukraine.

Despite current levels of gas production, it is estimated that Ukraine has 925 bcm of natural gas reserves, with only 2 percent of its reserves being extracted every year. (National Investment Council, 2017). Thus the potential for increased gas production to meet domestic supply gaps is a key declared priority for policymakers. As discussed in below sections, this priority is sometimes at odds with actual practices with regard to the governance of SOEs which are currently the biggest players operating in the sector. It is estimated that to reach its objective of more than 27 bcm annual production the industry will require around 6 billion USD of investment. The introduction of private competition into the market can also play a role in increasing the share of privately produced natural gas while also allowing for more investment in upstream technology and production capacities. (National Investment Council, 2017)

### *Natural gas import*

Imported gas plays a significant role in Ukraine's gas supply, fulfilling 30 per cent of domestic demand. In 2017, Naftogaz sourced 62 per cent of imported natural gas with the remainder provided by other market participants, representing a volume of 14.1 bcm (Naftogaz annual report, 2017).<sup>48</sup> With various policies aimed at opening up the energy sector to increased competition and market access to its European partners, as per Ukraine's commitment to see through the implementation of the "Third Energy Package" and commitments to international creditors, and efforts by Naftogaz to integrate into the European market, the number of independent gas importers has increased year-on-year from 19 importers in 2015 to 35 in 2016, and 66 in 2017 (Naftogaz annual report, 2017).

### *Gas transit, transport and storage*

Ukraine has the largest gas storage capacities in all of Europe making up nearly a third of the total EU-28 capacity. The technical working gas volume of underground gas storage facilities for Ukraine is 351 terawatt hours (TWh) (as of April 2016) (National Investment Council, 2017), of which approximately 40 per cent is being used (Naftogaz questionnaire response).

Extensive gas transport infrastructure in Ukraine ensures Ukraine's long established status of a transit country facilitating transit of natural gas from Russia to other markets. Due to its branching and accessibility, its gas infrastructure enables the transport of gas produced

in Ukraine to domestic consumers but also allows for uninterrupted transit to European consumers.<sup>49</sup> In 2017, transition of gas through the Ukrainian GTS remained one of the main ways of importing natural gas to the EU, and the amount of gas transiting through Ukraine was 93.5 bcm (Naftogaz annual report, 2017), representing an important source of income for Naftogaz and the government of Ukraine. According to the 2017 Annual Report of the company, 32.5% of the group's revenues come from gas transit alone (see section 2 for financial performance of Naftogaz). Ultimately this business line will be unbundled to an independent transmission operator according to Ukraine's commitments under the Third Energy Package. (EITI, 2016)

The reliability in the volume of gas transit from Russia via Ukraine depend on any future contract that is signed by relevant parties upon the expiry of Gazprom's current contract with Naftogaz set for 31 December 2019. The government reports that it will be necessary to develop measures that secure transit of natural gas to Europe after 2020, including by way of possible involvement of foreign partners in managing activities of the gas transportation system of Ukraine.

### *Energy strategy and plans for gas market reforms*

Gas sector reform has been one of the key elements of a broader energy strategy for Ukraine, due in part to its need to secure energy security, and to see through obligations set out in the aforementioned "Third Energy Package" of the EU. In 2015, Ukraine introduced a number of changes to gas market regulation, and adopted the Law "On the Natural Gas Market" which laid out the foundation for the harmonisation of the gas market in Ukraine with the Third Energy Package requirements. This law aimed to set in motion the fulfilment of the basic requirement of the Package including:

- to allow free third party access to the infrastructure, that assumes provision to all gas suppliers non-discriminatory access to gas transmission and distribution networks;
- regulated tariffs for gas transmission set by the independent energy market Regulator (as of 1 January 2016);
- abolition of price regulation; and,
- unbundling of gas transmission from supply and production.

The Unbundling Plan from 2016 (CMU Resolution 496) stipulates the "ownership unbundling model" as the model of choice for a future operator of the transmission system; the same was called for the unbundling of gas storage. The Unbundling plan envisages the establishment of two separate state-owned joint stock companies as operators for: gas transmission system of Ukraine – Main Gas Pipelines of Ukraine (MGU) - which currently exists under the oversight of the Ministry of Energy and Coal Industry - and for underground gas storage facilities – Underground gas storages of Ukraine (USU). The unbundling of transmission and storage assets were to be completed within 30 days of the completion of the Stockholm arbitration case (see Box 1.5).



### Box 1.5. Stockholm arbitration and resulting rulings

In 2014, Gazprom and Naftogaz launched claims against each other in the Stockholm Arbitration court, becoming one of the largest commercial arbitrations. Their legal battle has been regarded as a side effect of deteriorating relations between Ukraine and Russia following the annexation of Crimea and ongoing conflict in the Donbas region. After four years of proceedings, the Stockholm Arbitration delivered two rulings: the first on 22 December 2017 concerning a gas supply contract, and the second on 28 February 2018 regarding a gas transit contract. The court upheld Naftogaz's claim that Gazprom failed to meet the agreed transit volumes, awarding it \$4.63 billion in damages. But the court also ruled that Naftogaz should pay Gazprom \$2 billion for gas arrears.

Despite favouring Naftogaz, Ukraine continues to face challenges regarding the completion of its unbundling process and the future of gas transit routes:

a) The Stockholm Arbitration court did not approve transferring the gas transit contract with Gazprom to another operator. In addition, Gazprom refuses to change the transit contract that is valid until 31 December 2019, thus making it difficult for Naftogaz to unbundle its gas transportation function. For this reason, unbundling has been postponed until the expiry of Naftogaz's contract with Gazprom.

b) Ukraine faces uncertainty regarding its gas transit routes once the contract with Gazprom expires. The country has been the main route for carrying Russian gas to Europe, supplying a third of the total demand. In 2017, transit reached over 93 bcm out of Gazprom's export of 194 bcm to Turkey and Europe. Ukraine and Russia have agreed to hold talks with the European Commission regarding the future of the transit framework. However, Ukraine's position as a transit route may be threatened with the construction of the Nord Stream 2 pipeline, which is planned to be finalised in 2019. The undersea pipeline would bypass Ukraine and deliver gas directly to Germany through the Baltic Sea, thus strengthening Russia's hand in supplying gas to Europe.

Sources: Escritt, et. al. (2018); H.T. (2018); Olearchyk and Seddon (2017); Olearchyk (2018); Pirani (2018); Polityuk and Prentice (2018); Somer (2018); "Swedish court renews enforcement of \$2.6 bln from Gazprom – Naftogaz" (2018).

In 2017 the government took a step further and developed an energy strategy through 2035 (Resolution of CMU, 605-p). This high-level policy document sets forth the government plans to see through a transformation in its energy policies. It should be noted that the Energy Strategy remains a high-level document which does not mention specific objectives or the roles of the largest SOEs operating in the sector, including Naftogaz. More specific industry and SOE specific-objectives are set out through a series of resolutions, including notably the 2017 CMU Resolution "Concept of the Development of the Natural Gas Production Industry of Ukraine" which set targets for domestic gas production by SOEs to 20 bcm by 2020 (as noted above, see Figure 1.5).

The actual roll out of Phase I of the Energy strategy, seeing through the full implementation of the Natural Gas Market law, and the Unbundling Plan remain in "limbo" due to a number of factors, including a lack of clarity in the February 2018 ruling of the Stockholm Arbitration court vis-à-vis Naftogaz's and Gazprom's respective obligations with regarding the volume of Russian gas that will go through Ukraine for the duration of the contract (see Box 1.4). According to the latest available information at the time of writing, Naftogaz

and MGU (the future transit service operator - TSO) agreed on a memorandum of understanding regarding a roadmap towards TSO unbundling in Ukraine. Under the agreed Memorandum of Understanding, the unbundling process is to be finalized at the beginning of 2020, after the existing transit contract with Gazprom expires. It is also mentioned that MGU will serve as the operator of the gas transmission system as of 1 January 2020. Until that date, and as part of a transitory period, the functions of the TSO will be carried out on a joint basis with Naftogaz until the end of 2019 (Box 1.7).

#### Box 1.6. Energy Strategy of Ukraine through 2035

**The Energy Strategy of Ukraine was approved in 2017 following the approval of the Natural Gas Market Law. This high-level policy document sets forth the government plans to see through a transformation in its energy policies.**

The Energy Strategy 2035 is organised around six main objectives including : creating a "conscious and energy efficient society"; reaching energy security and reliability/sustainability of fuel and energy sources developing the possibility to export; development of an energy market; improving investment attractiveness; ensuring network integration system; and a modern management system. The roll out of the strategy is based on three "phases of reform", with relevant excerpts pertaining to the hydrocarbons sector, outlined as follows:

- Phase 1 on energy sector reform is aimed at, inter alia, seeing through the implementation of the reforms envisaged under the Third Energy Package by 2020;
- Phase 2 on optimisation and innovative development of energy infrastructure through 2025 which focuses, inter alia, on setting new market conditions for integration of the energy sector into the European system and with a focus on energy efficiency and saving measures. Notable to this review, improved corporate governance reform of economic operators is one key area covered; and,
- Phase 3 on ensuring sustainable development through 2035 envisages, inter alia, "innovative" development of the energy sector and construction of new energy generation capacities. Notable to this review is the focus on developing further natural gas extraction and adjustment of the gas transmission system to developments in the EU.

According to the Ministry of Energy and Coal, for each Phase of the strategy an action plan (not seen by the assessment team) has been developed which sets out key priorities including for relevant state-owned companies in the sector. However, according to the actual strategy itself does not mention Naftogaz nor its subsidiary companies and does not assign any objectives or actions for Naftogaz. The State Ownership Policy of Naftogaz does not have any reference to the Energy Strategy either.

*Source:* Energy Strategy of Ukraine 2035.

### **Box 1.7. Memorandum of Understanding between Naftogaz and MGU: Unbundling the Gas Transmission System**

The supervisory boards of Naftogaz and Mahistralny Gazoprovody Ukrainy (MGU) have reached an agreement to cooperate on unbundling Ukraine's gas transmission system. Under an approved Memorandum of Understanding (MoU) dating from July 2018, the parties have decided to complete unbundling by January 2020, after the expiration of the transit contract with Gazprom.

In working towards unbundling, Naftogaz, as the current owner of the transition system, is going to be responsible for internal preparation and resource allocation to ensure effective transfer. MGU will be responsible for certification, working on a new regulatory system with the Regulator, and implementing anti-corruption and corporate governance practices. To ensuring cooperation, the MoU expects the MGU supervisory board members to be appointed as advisors of their Naftogaz counterparts, as the parties participate in "Ethics and Unbundling" committee meetings and consult each other on decisions that may have consequences after 2019. MGU also seeks to issue monthly progress reports regarding unbundling, to prepare due diligence, to engage with relevant stakeholders, and to ensure sustainability of legal and regulatory framework from 2020 onwards.

However, Naftogaz and MGU currently face significant challenges in achieving unbundling. In addition to a tight deadline, MGU's limited financial capacity would limit its possibility to hire professionals and consultants to monitor and guide the process. Moreover, the success of unbundling is dependent on the coordination between MGU and Naftogaz, and on ensuring the commitment of the supervisory boards on both sides. Although the MoU provides general guidelines, it does not contain details regarding the coordination process.

Nevertheless, as a future transmission system operator, launching cooperation could have the following benefits for MGU:

- Obtain information regarding Naftogaz's technical, legal, and financial aspects necessary for unbundling;
- Be able to monitor Naftogaz's progress and advise the board and stakeholders regarding obstructions or delays;
- Assist in defining role and responsibilities for both parties in carrying out unbundling, thus enabling it to prepare to take over the assets;
- Allow both sides to collaborate on key issues over the next 15 months, such as negotiating future transit contract with Gazprom and cooperating with foreign transport system to boost Ukraine's gas transmission system efficiency; and
- Seek support from international donors to launch a project that would contribute to further developing the gas market in Ukraine.

*Source:* Letter from W. Boltz, Chair of the MGU Supervisory Board, 26 Sep. 2018.

## *Gas prices, public service obligations and subsidies*

### *Gas Prices*

Prior to 1 October 2015, natural gas prices for all consumer groups, as well as tariffs on its transport, distribution, storage and supply were subject to state regulation following procedures defined by the National Commission for the State Regulation in the Energy and Public Utilities (the Commission previously existed under a different name). End-user gas prices covered the weighted average price of gas as commodity (purchased from state-owned domestic producers), operational costs, special surcharge, transport and supply tariffs and VAT. Marginal (highest) prices for industrial consumers and publicly funded institutions were defined based on the prices of imported gas and costs incurred by Naftogaz, and were revised regularly (NERC, 2015a).

Procedures on tariff setting were modified considerably when Law No. 329-VIII (2015) on the gas market came into effect, with the aim of, *inter alia*, liberalising gas prices in the wholesale and retail gas market. However CMU currently assigns special responsibilities to Naftogaz for the delivery of natural gas under the public service obligation (see also below). (OECD, 2018b)

In the transition period from 1 October 2015 to 30 April 2016, gas prices for households and heat supply companies providing heat for household needs were defined by the Cabinet of Ministers (Cabinet of Ministers Resolution No. 758, 2015 “On approval of the assigning of special responsibilities of the natural gas market players to ensure interests of the general public”. Gas prices for industrial and other consumers, which are not covered by the above resolution, are defined and established by gas market players independently. (OECD, 2018b).

The issue of gas price remains significantly politicized, and it is subject to significant debate in Ukraine. Although recognising the need to reflect market prices, raising gas prices, especially for certain categories of consumers, remains a sensitive topic. Raising gas prices has been unpopular with large proportions of the population and thus changes have been made incrementally. On 28 September 2018, the CMU extended the PSO regime until 18 October 2018.

On October 19, 2018 the Cabinet of Ministers of Ukraine passed a Resolution No. 867 according to which gas prices for household and retail consumers were raised and will be aligned with the market prices gradually but not later than May 1, 2020.

### *Public service obligation*

Naftogaz has historically been an important vehicle through which the state has fulfilled public policy objectives, such as the delivery of gas to households at below market prices. According to the law, Naftogaz is required to sell gas at regulated prices. Since the (partial) privatisation of gas distribution companies, it is well-documented that this sale happens via dubious intermediaries involved in the retail gas supply segment (Francis, 2018) (Borosovskyi, 2017) (Kharchenko, 2018) (Konończuk and Matuszak, 2017).

The 2015 Natural Gas Market Law introduced a public service obligation regime and allowed the CMU to assign it to natural gas market players. Naftogaz was assigned PSO supplier status from 1 October 2015 and was subsequently required to sell/supply gas at a defined price to certain customer categories (first of all regional supply and district heating companies). The Law also stipulated the right of Naftogaz to be compensated for economically justifiable costs incurred fulfilling gas supply under PSO status, net of

obtained revenue. Importantly, the compensation is not linked to purely covering the deficit but should cover the difference between market-based and PSO-based economics of gas supply. However, the law does not define the PSO compensation mechanism (although it says that such mechanism should be developed by CMU) and hence has never been applied. The compensation mechanism and coverage of losses incurred by Naftogaz continue to remain a contentious issue.

However, considering that Naftogaz also imports a portion of gas from external suppliers to fill in supply gaps, Naftogaz has continued to bear financial consequences from differences between the market price and the PSO price - as of April 2018 Naftogaz reports that the market price was more than 50%. (Naftogaz questionnaire responses). The actual impact on the company's balance sheet and compensation mechanisms will be discussed in more detail in the below sections. However it is worth noting that price regulation is the source of Naftogaz' consistent historical negative financial performance in this segment.<sup>50</sup>

### *Subsidies*

Energy subsidies are particularly large in size. By some accounts, which also calculate indirect subsidies, energy subsidies are estimated at 7.5 percent of GDP (OECD, 2018b). They stem from lower prices charged to final consumers and energy distribution companies, as well as lower sale prices (compared to international benchmarks) of domestically extracted and refined gas sold on the local market by Naftogaz. During 2014, tariff increases were introduced for consumers and gas price charged to energy distribution companies, which in part reduced the subsidy rate but was offset by the exchange rate depreciation. In the absence of further price corrections, the government budget still needs to fund losses incurred by Naftogaz as a result of the public service obligations policy. (OECD, 2018b)

While the indirect subsidies volume is big, they do not fairly benefit the vulnerable consumers. Instead these subsidies disproportionately benefit better off households as they are mainly benefitting households in urban areas, and are misused by rent-seeking intermediaries involved in the “last mile” of the gas supply chain (see Box 1.8 and Figure 1.6). In July 2018, following a case opened up by the EU Energy Community (case ECS-2/17), the EU Secretariat has determined that “the provision of natural gas to Naftogaz, natural gas retail suppliers (*Obligates*) serving household customers and religious organisations as well as to district heating companies at regulated prices under PSO constitutes illegal State aid.” (ECS-2/17)

**Box 1.8. Challenges with corruption in the hydrocarbon supply chain and the “Last Mile” to the end consumer**

Challenges remain regarding the delivery mechanism of gas to consumers, or, the so-called “last mile” in the supply chain to reach the end consumer. Based on the current structure, Naftogaz purchases gas from its own subsidiary, Ukrgasvydobuvannya (UGV), and import other suppliers. Under their sales contracts with Naftogaz, they transfer gas through Ukrtransgas (UTG) – another Naftogaz subsidiary- and provide it to Municipal Heating Enterprises (MHEs) and Distribution System Operators (DSOs) for delivery to consumers. The MHEs operate a heat distribution system and municipally owned assets, and supply consumers with heat energy and hot water. DSOs are used to distribute gas through low-pressure pipelines to consumers, as well as to MHEs. However, Regional Supply Companies (RSCs, or *oblgases*) control 70% of the DSOs, in which Naftogaz’s stake is minimal.

The RSCs have maintained monopoly acting as intermediaries in distributing gas to regulated markets. Under the current structure, the RSCs purchase gas from Naftogaz at below market price, which they distribute to households using DSOs in exchange for payment. However, vested interests and corruption schemes, including selling gas to fictive consumers, have led these companies to accumulate billions of UAH of debt to Naftogaz. In addition, they have bypassed commitments to unbundle selling and transporting gas by establishing separate entities that sell gas to households.

Further issues involve the lack of clarity regarding the extent of their ownership of the network distribution system, which has been difficult to resolve given the absence of an inventory of gas pipelines. While maintaining control over distributing gas to households, the RSCs have lobbied for introducing legislation to gain additional control over tariff collection and cancelling debt owed to Naftogaz, which could undermine the reform process.

Sources: Borosovskyi (2017); Kharchenko (2018); Konończuk and Matuszak (2017).



<sup>7</sup> It should be noted that the CMU considers the resignation of the board to demonstrate its true independence.

<sup>8</sup> One of the four independent members appointed has refused the position and has not attended any board meetings.

<sup>9</sup> <http://www.naftogaz.com/files/Information/EBRD-Action-Plan-engl.pdf>

<sup>10</sup> <http://www.naftogaz.com/www/3/nakweben.nsf/0/6D7C544D5F376866C22581A0006883A0?OpenDocument&year=2017&month=09&nt=News&>

<sup>11</sup> The Ukrainian authorities report that the Nordstream pipelines are designed to double the existing gas transmission capacity between Russia and Germany. If built, apparently two-thirds of Russian gas deliveries to the EU could be concentrated in the offshore Nord Stream 1 and 2 pipelines, both controlled by Gazprom.

<sup>12</sup> Pursuant to the Law of Ukraine “On depository system of Ukraine”, there can be only one central depository (that one being National Depository of Ukraine), apart from the National Bank of Ukraine that keeps record on certain types of securities (state securities and bonds).

<sup>13</sup> The Strategy of National Security of Ukraine in 2015 set forth “limitations aimed at preventing the penetration of capital from the "Aggressor-state" in strategic sectors of the economy to ensure the economic security of Ukraine. (OECD, 2017)

<sup>14</sup> The Ukrainian Corporate Governance Academy has issued a set of Recommendations on the Governance of State-Owned Enterprises, which draws on international best practices, and provides targeted recommendations adapted to the Ukrainian context:  
[https://ucga.com.ua/sites/default/files/pdf/Resommen\\_ENG.pdf](https://ucga.com.ua/sites/default/files/pdf/Resommen_ENG.pdf)

<sup>15</sup> These include: National Anti-Corruption Bureau; Specialized Anti-Corruption Prosecutor’s Office; National Agency on Corruption Prevention; and the National Agency of Ukraine for Finding, Tracing and Management of Assets Derived from Corruption and Other Crimes.

<sup>16</sup> EBRD technical cooperation projects: (i) Ukraine: Prozorro Project Implementation Support, and (ii) Public Procurement: Policy Advice and Legislative Drafting for eProcurement reforms

<sup>17</sup> <http://www.atlanticcouncil.org/blogs/ukrainealert/ukraine-must-privatise-failing-state-owned-enterprises-quickly>

<sup>18</sup> <http://sigmaweb.org/publications/Baseline-Measurement-Report-2018-Ukraine.pdf>

<sup>19</sup> <http://carnegieendowment.org/2017/04/19/ukraine-reform-monitor-april-2017-pub-68700>

<sup>20</sup> Based on the data provided it is not evident whether subsidiaries are counted separately in the aggregate data and when broken down by ownership entity. For example, it is unclear whether corporatized subsidiary companies of holding companies, such as Naftogaz, are counted separately.

<sup>21</sup> The State Property Fund holds a central registry for government property which relies on state bodies to self-register state-owned enterprises. The SPF reports that the registry is not updated by ownership entities, and therefore cannot be considered complete; moreover it is only mandated to collect information on a sub-set of the SOE portfolio, namely unitary enterprises.

<sup>22</sup> For the purposes of the SOE Guidelines an economic activity is one that involves offering goods or services on a given market and which could, at least in principle, be carried out by a private operator in order to make profits.

<sup>23</sup> Only partial information has been made available for the first half of 2017, which indicates the value of assets to UAH 1 446 billion (representing 0.4% growth) and the revenue for the first half of 2017 amounted to UAH 224 billion, which is 24% higher if compared to the figure from the first half of 2016. (MEDT, 2017)



<sup>24</sup> It is worth noting that the predominant form of SOE in Ukraine is the "state unitary enterprise", which can either be classified as a "Kazenni" or "commercial entity". The Kazenni are fully controlled by the government and are provided with operational management rights. Similarly, commercial entities are fully controlled by the government, but are granted business management rights and operate on a for-profit-basis. (IMF, 2016) An earlier OECD study (OECD, 2012) reviewing the corporate governance of the state unitary enterprise Antonov identified a number of challenges with the unitary enterprise form of ownership. This legal form essentially allows SOEs to operate as extensions of government without the requisite legal personality and obligations that come with being incorporated, for example with regards to governance, transparency, auditing, and exposure to bankruptcy, etc. Recent reforms have tried to align the practices of unitary enterprises with JSCs, for example by requiring the commercially operating unitary enterprises to have audited financial statements; and gradually a select number of key unitary enterprises have been included in government plans to put in place supervisory boards with independent directors.

<sup>25</sup> This is done through the State Audit Service (SAS), formerly known as the KRU.

<sup>26</sup> <https://zakon.rada.gov.ua/laws/show/1044-2016-%D0%BF#n1305>

<sup>27</sup> According to IMF, 2016 the evaluation exercise assesses the efficiency of governing bodies' ability to implement their financial plans, with a scoring system with three broad categories: positive, satisfactory, or negative. The evaluation of SOE governing bodies is reportedly not done in a systematic way and the results influence neither hiring/firing decisions, nor remuneration practices. (IMF, 2016)

<sup>28</sup> <https://mfa.gov.ua/en/news-feeds/foreign-offices-news/65813-the-government-of-ukraine-approved-the-list-of-23-large-state-owned-objects-to-be-privatized-in-2018>

<sup>29</sup> Holding company for the purposes of this report means "parent company", but not a (state) holding company in terms of the Law of Ukraine "On Holding Companies" dated 15 March 2006 No. 3528-IV.

<sup>30</sup> <https://mg.org.ua/en/the-supervisory-board-of-the-pjsc-%E2%80%9Cmgu%E2%80%9D-will-be-headed-by-walter-boltz.html>

<sup>31</sup> [https://www.ecfr.eu/page/-/ECFR\\_160\\_SURVIVAL\\_OF\\_THE\\_RICHEST-HOW\\_OLIGARCHI\\_BLOCK\\_REFORM\\_IN\\_UKRAINE.pdf](https://www.ecfr.eu/page/-/ECFR_160_SURVIVAL_OF_THE_RICHEST-HOW_OLIGARCHI_BLOCK_REFORM_IN_UKRAINE.pdf)

<sup>32</sup> [https://www.ukrinform.net/rubric-other\\_news/1336710-naftogaz\\_of\\_ukraine\\_hands\\_over\\_65\\_of\\_shareholdings\\_in\\_oblgazes\\_to\\_spfu.html](https://www.ukrinform.net/rubric-other_news/1336710-naftogaz_of_ukraine_hands_over_65_of_shareholdings_in_oblgazes_to_spfu.html)

<sup>33</sup> OECD, 2018a, and <https://www.kyivpost.com/business/energy-reform-sputters-firtash-said-get-billions.html>

<sup>34</sup> The NCSREPU combines the previously separate National Commission for State Regulation of Public Utilities and the National Commission for State Regulation of Energy and Utilities. It also replaced the National Electricity Regulatory Commission, dissolved in 2014.

<sup>35</sup> *Oblenergos* are regional monopolies responsible for distribution and supply to residential and industrial consumers at NEURC-regulated tariff rates.

<sup>36</sup> [http://geoinf.kiev.ua/wp/wp-content/uploads/2016/04/SGSSU\\_Assessment.pdf](http://geoinf.kiev.ua/wp/wp-content/uploads/2016/04/SGSSU_Assessment.pdf)

<sup>37</sup> <http://www.geo.gov.ua/derzhgeonadra-prodovzhili-39-specdozvoliv-at-ukrgazvidobuvannya/>

<sup>38</sup> According to OECD, 2017 this provision was responsible for barring European telecom companies – including Deutsche Telekom and Norway's Telenor – to penetrate the fixed-line telecommunication market, following 2010 plans to privatise the incumbent Ukrtelecom. There are, however, no restrictions on the resale of privatised shares by residents to non-residents or established foreign-controlled enterprises on the secondary market.

<sup>39</sup>[http://www.cms-lawnow.com/ealerts/2015/05/ukrainian-government-launches-largest-privatisation-programme-in-20-years?cc\\_lang=en](http://www.cms-lawnow.com/ealerts/2015/05/ukrainian-government-launches-largest-privatisation-programme-in-20-years?cc_lang=en)

<sup>40</sup> In 2015, the Cabinet of Ministers approved plans to privatise eighteen state-owned companies (SOEs), including the Odessa Portside Chemical Plant. This was meant to be the first large-scale privatisation since 2014, after which other SOEs would follow suit. However, the plant's sell-off was unsuccessful due to challenges in attracting investors. The initial attempt to privatise it for \$521 million was launched in July 2016, which fell through as international donors warned that the government's management of the transaction was not appealing to credible bidders. During the second auction months later, the government cut the bidding price to about \$200 million, yet failed to receive offers given the uncertainty surrounding the plant's debts (OECD (2018—Anti-Corruption Reforms in Ukraine: Prevention and Prosecution of Corruption in State-Owned Enterprises); Olearchyk (2016); Zinets and Prentice (2016)).

<sup>41</sup> <http://www.cms-lawnow.com/ealerts/2018/03/ukraine-new-privatisation-law-came-into-force>

<sup>42</sup> <http://www.privatisation.gov.ua/en/>

<sup>43</sup> <https://www.reuters.com/article/us-ukraine-crisis-privatisation-idUSKBN13W1CH>

<sup>44</sup> <http://www.atlanticcouncil.org/blogs/ukrainealert/ukraine-is-serious-about-privatisation-this-time>

<sup>45</sup> It should be noted that the list of enterprises and state assets that cannot be privatised is determined by the Ukrainian Parliament.

<sup>46</sup> Donbass which has the largest reserves of coal and is unattainable by Ukraine due to Russian occupation.

<sup>47</sup> These companies include: DTEK; Burisma; Smart-holding; Geo Alliance; UkrNaftoBurinnya; Cub Gaz; JKX; and others.

<sup>48</sup> This has been achieved through revolving facilities financed by the EBRD where the implementation of the Corporate Governance Action Plan was a covenant.

<sup>49</sup> According to EITI's 2016 assessment the Ukrainian gas transport system includes 38.55 thousand km of gas pipelines, including 22.16 thousand km of trunk pipelines and 16.39 thousand km of gas pipelines branches.

<sup>50</sup> Historically speaking the company has accumulated losses from a lack of formal compensation of difference between market and regulated prices. Instead of formal compensation, Naftogaz' deficit was covered by UAH-denominated domestic government bonds (i.e. "OVDP") which the company received in return for additionally issued share capital. While such financial support from the state can be considered a price difference compensation, there is no legal base or documentation confirming this is the case as well as there is no official calculation of Naftogaz' loss and its compensation by the state through Naftogaz' share capital contribution through such bonds. Moreover, such financial support was used to cover all financial deficit of Naftogaz, which was often explained not only by price differences. If Naftogaz had been formally compensated in cash for the price, such cash inflow would be accounted for as income, reducing the loss, the timing and legal form of such compensation is not defined.

## Chapter 2. Naftogaz as a case study

### Introduction to Naftogaz

Naftogaz (NAK) is the national incumbent oil and gas company of Ukraine. Apart from purely commercial operations, NAK plays an important social role as seller of natural gas to retail supply companies for the needs of domestic consumers, and supplier of natural gas to religious organizations and utilities at prices set by the state as part of its public policy objectives.

Although the company is at the centre of the oil and gas industry, and in contributing to Ukraine's goals (as explained above) to reach energy security and secure supply of natural gas domestically and transit internationally, according to the company's management team. Recent corporate governance and other reforms have strengthened the group, with increased centralisation of the main functions of the company. However, due to intervention in the company's affairs, and difficulties with further market transformation due to vested interests that control or interfere in the company's or its subsidiaries' operations, many challenges remain. The situation is further complicated by a lack of control over its assets, including ambiguities of the status of the assets (shares) contributed to the share capital of the company. As the government reserves the right to approve business transactions, including those that are not considered "exceptional" and thus covered by basic shareholder rights, this further weakens management's powers.

### *History of Naftogaz*

Naftogaz is a successor of the State Committee of Oil and Gas, which was established in 1993 as a legal entity with a status of central executive body, subordinated to the Cabinet of Ministers of Ukraine. The State Committee of Oil and Gas controlled all state-owned oil and gas companies at that time: Ukgazprom (gas production and transmission), Ukgaz (gas distribution), Ukrnafta (oil), Chernomornaftogaz (assets in Crimea), and oil transmission and downstream companies. Following privatisation of some assets of the State Committee in the mid-1990s, major market failures resulted in a supply crisis with gas imports and in ensuring an overall security of supply.

As a result, Naftogaz was established in 1998 as an operating holding company for the remaining assets under control of the State Committee of Oil and Gas of Ukraine pursuant to CMU Resolution 747 "On establishment of National Joint-Stock Company "Naftogaz of Ukraine"<sup>51</sup>. Given the market failures that resulted from failed privatisation, the creation of Naftogaz, at the time, was rationalised by the need to:

- ensure secure gas supplies (both for consumers in Ukraine and transit of Russian gas to Europe);
- leverage synergies across the assets and provide for controlled privatisation;
- improve payment collections for the gas consumed, decrease transaction costs between entities of the group;

- procure Turkmenistan natural gas in exchange for product supplies from Ukraine;
- procure Russian gas in exchange for the Russian gas transit to Europe; and
- satisfy delivery of subsidised energy to the domestic population as an element of “Soviet” legacy.

As outlined above, Naftogaz as a parent company remains 100 percent state-owned with the Cabinet of Ministers acting as the entity authorised to manage corporate rights of the State (the Ownership Entity). Prior to the corporate governance reform of the company which commenced in 2015, shareholder rights over Naftogaz were held by the Ministry of Energy and Coal and were subsequently transferred to Ministry of Economic Development and Trade in December 2015.

The Corporate Strategy of Naftogaz today (developed by the Executive board and endorsed by the Supervisory Board in 2017) aims for Naftogaz “to be the leading engine of modernization and professionalism of the Ukrainian energy sector, integrated with the European market, ensuring security of supply and competitively priced energy while maximizing value of local resources.” The strategy outlines five key objectives for Naftogaz to pursue:

- ensure competitive prices of natural gas for Ukraine
- ensure security of energy supply
- increase oil and gas reserves and production
- facilitate improvement of energy efficiency and develop local supply chain; and
- maximize value of Naftogaz assets and improve health, safety and environmental issues.

It should be mentioned that at the time of writing, Naftogaz’s corporate strategy had not yet been approved by the government shareholder.

### ***Overview of corporate structure***

Naftogaz today has a corporate structure of a joint stock company bringing together subsidiary companies operating either as: “daughter” companies, i.e. subsidiaries that it has established; subsidiary “business” companies incorporated or solely owned by Naftogaz; and “subsidiary–companies” that have been partly privatised but partly-owned by Naftogaz. There are essentially three forms of subsidiaries that sit under the parent company these include (see overview Figure 2.1):<sup>52</sup>

- *Category 1- Subsidiary companies established by Naftogaz:* Subsidiary (daughter) companies which are not classified as business companies (“corporations”) according to the law and which were established by Naftogaz. The company is the sole owner of these subsidiaries;
- *Category 2 - 100% owned Business companies:* Business companies (joint-stock and limited liability companies) where Naftogaz holds 100% of shares. This category notably includes the large UTG and UGV companies; these companies have their own executive boards, and are not subject to the same level of “subordination” to the parent company as in Category 1; and,
- *Category 3- Partly owned Business companies:* Naftogaz also partly owns shares in 18 separate entities (six of which are owned at more than 25 %). This sub-group

can be divided into those companies where Naftogaz is majority shareholder (the most important being “Ukrnafta” and “Kirovogradgaz”) and those where it is not.

Naftogaz also owns shares in 38 local gas distribution and gasification companies which have been included in a separate category in the Figure. Although Naftogaz ownership remains non-trivial in these regional companies - in most cases 25 percent plus 1 share - as discussed earlier control of these entities remains under groups with known links to oligarchs.

It should also be added that Naftogaz subsidiaries have their own subset of subsidiary companies (see Table) operating in a range of sectors beyond hydrocarbons, such as in agriculture, food processing, health services, real estate and hospitality. Finally, Naftogaz has "representative offices" or branches in eight different locations. These offices have their own legal personality but are not significant in terms of their business operations.

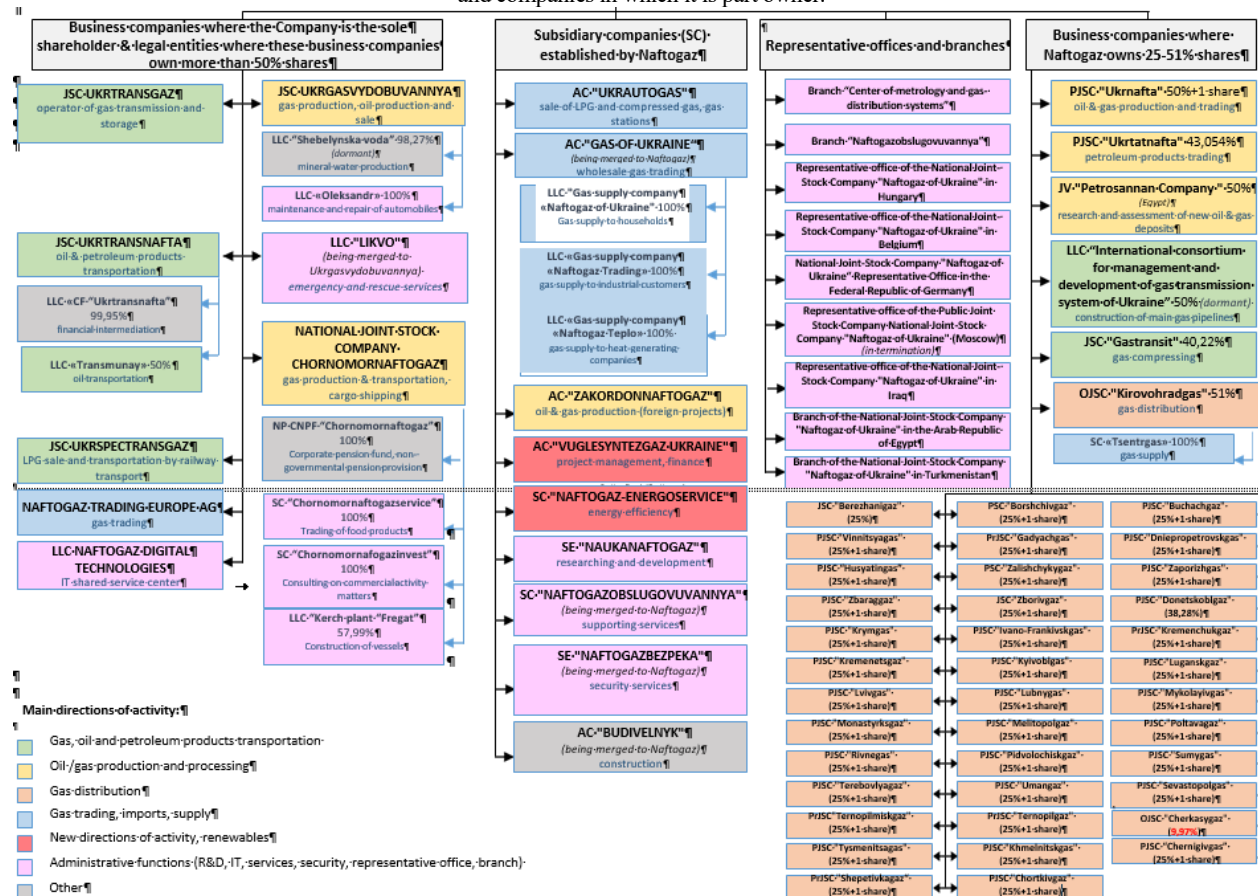
### *Legal relationship with subsidiaries*

Pursuant to Resolution 747, the share capital of the company was formed by bringing together a number of state-owned companies and shares of partly-privatised companies under the umbrella of Naftogaz as the parent company. The assets transferred to the share capital of the Company in 1998 were further used for establishment of the Company's subsidiaries, which until 2012 existed in the form of subsidiary enterprises. These subsidiaries were corporatized into joint-stock companies in 2012, which some observers believe, was intended as a precursor to privatisation. Naftogaz's title to some of shares transferred to its share capital has been challenged in court. Although court rulings confirm Naftogaz's full title to the shares in its subsidiaries, there is no legal clarification of this issue to date, which Naftogaz claims can open up opportunities for future challenges, including external interference. A recent incident where the government modified Naftogaz's Charter to obtain direct control over its subsidiary – Ukrtransgaz - demonstrates the possibility for future challenges (see Box 2.1). The assessment team was unable to obtain information from the government on the rationale for this incident.

In terms of the management and oversight of its subsidiaries, the individually incorporated subsidiaries and the consolidated holding company model poses an additional challenge in that the parent company has had weak central functions and capabilities and limited control over the activities of the subsidiaries. Its corporate governance reforms over the three years have aimed to establish a "strategic controller" model for the parent company which, *inter alia*, would enable strengthening its role at the centre. It is also intended to ward off *ad hoc* political intervention in the subsidiaries of the company.

Figure 2.1. Corporate Structure of Naftogaz

Naftogaz has three main types of subsidiaries that it owns, namely subsidiary companies it has established; business companies in which it is the sole shareholder; and companies in which it is part owner.



Source: Naftogaz, 2018.

### *Financial performance*

The Naftogaz annual report for 2017, for which financial statements were audited by an independent external auditor, found that for the 2017 financial year Naftogaz was operating at a net profit of 39.4 billion UAH, and at a net profit for the 2016 financial year of 17.8 billion UAH. These positive numbers follow prior years when the group had negative financial results. The partial convergence in the regulated price of gas with market price level has helped results from 2016 onwards (see table 2.1). However, the change in gas price, alone, has not been the only factor.<sup>53</sup> In 2017 the positive effect of the final award on the dispute over gas transit and gas sales from the Stockholm Arbitration with Gazprom contributed to the group's positive results for 2017.<sup>54</sup> It should be noted that individual subsidiaries also disclose their annual financial statements; however as the parent company's financial statements represent the consolidated figures for the group, these have not been looked at separately in the context of this report.

**Table 2.1. 2017 Naftogaz Consolidated Group key figures: profit and losses, in million UAH**

	2017	2016
Revenue	227,478	192,764
Cost of sales	-157,147	-121,804
Gross profit	70,331	70,960
Other operating income	5,092	2,627
Income recognised per results of Gas Transit Arbitration	57,125	
Other operating expenses	-27,475	-45,545
Expense recognised per results of Gas Sales Arbitration	-44,528	
Operating profit	60,545	28,042
Finance costs	-8,302	-9,581
Finance income	1,598	5,913
Net foreign exchange loss	-1,043	-5,790
Profit before income tax	52,751	18,485
Income tax expenses	-13,302	-636
Net profit for the year	39,449	17,849

Source: Naftogaz annual report, 2017.

In 2017 the bulk of Naftogaz' 227.5 billion UAH revenues came from its gas sales and supply business (which includes production and imports of natural gas). If combined to include households and industry in both the regulated and unregulated segments of the business (see table 2.2), which it supplies from domestically produced gas provided by subsidiary UGV and imported gas from various sources, these segments account for 39% of the company's revenue stream in 2017. The next revenue generating part of its business comes from natural gas transit (32.5% of revenue); followed by gas transmission and storage (11.0%); petroleum product sales; oil and gas condensate products; oil transit; and domestic oil transmission. (See overview in Table 2.2)

The gas sales and supply business of Naftogaz is made up of four different groups of customers in respect to gas production, imports, sales and supply that impact its financial performance. These groups include: (1) sales to regional gas supply companies for households; (2) sales to municipal heading enterprises (MHE) for the needs of households; (3) sales to other customers under PSO; (4) supply to other customers outside of PSO. As outlined in table 2.2 and drawn from the analysis provided in the 2017 Annual Report of Naftogaz, each of these segments is subject to a different price regime and economic

characteristics, such as product delivery, which impact the company's overall performance, cash flow, and balance sheet.

When looked at individually the regulated portions of Naftogaz's gas supply business are among the weakest performing, and given that these segments dominate the overall sales volume of the company, this has had an impact on overall financial performance. Losses from gas sales segment have outweighed gas transit segment's profitability, driving negative financial results for Naftogaz overall up until 2016, when partial convergence between regulated and market gas prices allowed to reduce losses in PSO segment sales. Together with other key changes made by Naftogaz' management (e.g. positive impact from diversification of gas imports, gas production growth, savings on materials, equipment and services purchases), the company has only recently been able to achieve a positive return on equity and return on assets.

### *Public service obligation and performance of Naftogaz*

The performance of Naftogaz is heavily impacted by its operations under the PSO regime. Naftogaz is legally obliged to sell or supply gas at the regulated prices set below market level to regional gas supply companies controlled by private interests as well as to district heating enterprises (about one-third of the market). Naftogaz has experienced problems collecting payments for sold or supplied gas from both groups of customers and has seen the accounts receivable increasing substantially over the past two years, while it is obliged to continue providing gas under the PSO regime (in many cases not paid or not paid within the agreed timeframe). As of 2017 year-end, both district heating and regional supply companies accumulated UAH 44.2 billion accounts receivable for natural gas supplied by Naftogaz. Additionally, Naftogaz has also accumulated over UAH 20.0 billion as of 2017 year-end (most of which in 2017) of debt for imbalances owed by gas distribution companies, estimated mostly to be due to unauthorized gas withdrawal (by district heating companies in particular). Because of these non-payments Naftogaz' gas business needs to be cross-subsidised by the gas transit business. In particular, this led to depressed operating cash flow margins (negative for district heating companies segment in 2016-2017) as well as return on invested capital level far below cost of capital.

Naftogaz estimates that from 2015 to 2017 losses related to its public service obligations amount to a total of UAH 111 billion which includes UAH 75 billion in foregone revenue, UAH 24 billion in accounts receivable bad debt reserves and UAH 12 billion in other related losses. These can be observed in figures for return on invested capital of Naftogaz in relevant business segments (see Table 2.2).



**Table 2.2. Performance of Naftogaz business segments**

	Revenue from this segment out of total	Return on invested capital (ROIC)*	Cost of capital**	Subject to PSO regime	Key issues
Sales to regional gas supply companies for households	23.9 %	4.5%	18.7%	YES	Below market price under PSO Owed debt by retail gas supply companies which act as intermediaries between Naftogaz and households under existing PSO regime
Sales to municipal heat generating entities (DHCs) for the needs of households	10 %	3%		YES	Below market price under PSO Sourcing of gas both from imports and domestic production by the group. Financially unsustainable model of residential municipal heating "business" translates into low payment discipline among this segment's customers
Sales to other customers under PSO	3%	3.2%		YES	Below market price under PSO
Supply to other customers outside PSO*	12%	13.4%		NO	
Gas transit	32.5%	3%	11.9%	NO	Most capital-intensive (35% of PP&E carrying value) business of Naftogaz group.
Gas domestic transmission	12.2%	0.01%		NO	Accumulation of debt for unauthorized gas offtakes; non-payment at domestic entry points
Gas storage	< 1%	0.35%		NO	Second most capital intensive business, but low demand for gas storage Low utilization of gas storages Low storage tariffs
Petroleum products sales	8%	13%	20%	NO	Suboptimal utilization of refining capacity Loss-making fuel retail businesses
Oil and gas condensate	6%	16.6%	22%	NO	High tax liabilities; risk of special permits being revoked or not renewed.
Oil transit	2%	19.9%	17.4%**	NO	Unregulated tariffs, low invested capital Dependence on single customer
Oil domestic transmission	< 1%	-6.3%		NO	Low use of system; maintenance and repair; Regulated tariffs that don't cover operating costs;

Note: \*) ROIC is calculated as NOPLAT divided by invested capital, which was determined as a sum of invested capital in fixed assets and net working capital as of the end of the year. Invested capital in fixed assets was calculated based on estimated opportunity costs or net replacement costs of invested assets.

\*\*\*) Cost of capital is estimated by independent appraisers to determine the fair value of property, plant and equipment of Naftogaz as of 31.12.2017.

Source: Author's compilation based on 2017 Annual Report.

## ***Taxation and dividends***

### ***General taxes and resource royalties***

Naftogaz as well as its subsidiaries are subject to the general taxes and duties applied to all corporate businesses in Ukraine (value added tax, corporate income tax, payroll taxes and other related charges). In 2017, the Naftogaz group paid a total of UAH 96.7 billion of corporate income, value added taxes, and royalties to the state budget, representing 25% more than in 2016.<sup>55</sup>

VAT payment is the biggest component of the overall taxes volume paid by Naftogaz and its subsidiaries to the budget. The VAT payment has increased due to natural gas prices increases in 2015 and 2016, as well as the introduction of a 20 per cent VAT taxation of natural gas transit operations which started as of 1 January 2016.<sup>56</sup>

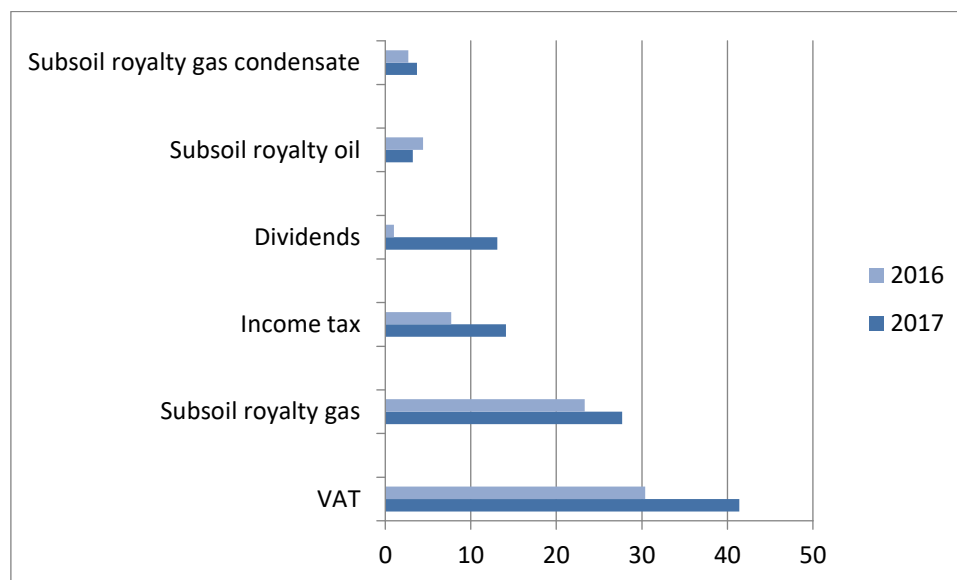
Royalty payments come second in line in terms of payments by Naftogaz. These rates have been subject to various adjustments over the last few years.<sup>57</sup> The latest applicable royalty rates are as follows:

- Natural gas production: 29% (12% for wells drilling of which started after 1 January 2018) for production from seams less than 5,000 meters deep and 14% (6% for wells drilling of which started after 1 January 2018) for seams over 5,000 meters deep (as of 1 January 2018, before that only 29%/14% royalty rate regime was in place)<sup>58</sup>
- Oil and gas condensate: 45% for production from seams less than 5,000 meters deep and / 21% for seams over 5,000 meters deep (as of August 2014) - these will be lowered to 29% and 14%, respectively as of 2019.
- Oil production: 29% for production from seams less than 5,000 meters deep and 14% for seams over 5,000 meters deep (as of 2017).

The third in line in terms of budget contributions for Naftogaz are corporate/income tax, for which the rate is uniformly set at 18 per cent. (Figure 2.2)

**Figure 2.2. Tax payments, royalties and dividends, in UAH billion**

VAT and subsoil royalty charge for gas remain among the highest sources of duties for the company.



Source: Adapted from Naftogaz annual report, 2017.

### *Dividends*

As discussed further below, there is a mandatory dividend pay-out percentage in Ukraine for state-owned enterprises defined by the CMU each year. The rate established by the state for almost all SOEs, including Naftogaz, has ranged from 50-75%.<sup>59</sup> However, at the group level this is based on net profit of the reporting period or other distributable reserves not exceeding retained earnings as calculated in the financial statements prepared in accordance with International Financial Reporting Standards. As a result of this legislation, Naftogaz as a parent company had not paid dividends from 2012 through 2015. For the first time since 2012, the company paid UAH 13.3 billion in dividends to the state budget for 2017, representing 50% of 2016 net profit.<sup>60</sup> Naftogaz paid UAH 29.4 billion or 75% of 2017 net profit to the state budget in 2018.<sup>61</sup>

Some of Naftogaz subsidiaries also make direct dividend payments to the state based on their own financial results. Therefore, during the same periods discussed above, profitable subsidiaries were continuing to make dividend payments to the state based on the obligatory rate set by the CMU in the applicable year. The company management considers this in conflict with accounting rules and company law (stating the right to collect dividends belongs to the shareholder only, i.e. not to the shareholder of the shareholder). At the time of writing draft law 6428 has been under consideration by the Parliament which could potentially clarify these inconsistencies.

### *Funding and financing of Naftogaz*

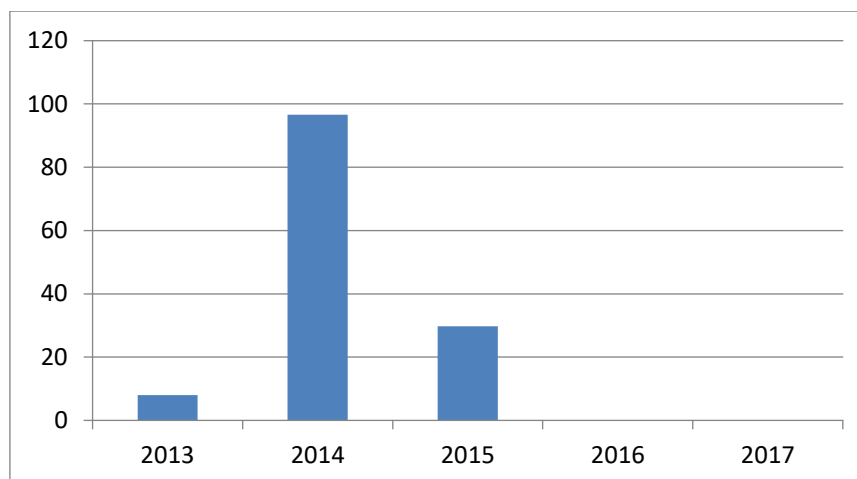
Based on the financial position of the company reported for 2017 and 2016, there was a decrease in the debt to equity ratio, with the ratio decreasing from 0.16 in 2016 to 0.13 in 2017 (Naftogaz, 2018). Overall, the ratio is below the range of what is observed for other companies in the oil and gas sector. The main sources of financing for Naftogaz are as follows:

- Equity capital through capital injections by its state-owner and fixed assets revaluation reserve;
- Bond issuance;
- Borrowing primarily through state-owned financial institutions; and,
- State-guaranteed borrowing through international financial institutions.

Equity has been the dominant share of the total capital volume staying at or above 85% of total capital since 2014. Two key sources of equity increase have been state capital injections used largely to offset Naftogaz annual deficit and increase in fixed assets revaluation reserve. The biggest share capital contribution occurred in 2014 to support Naftogaz in weathering the financial deficit of USD 9 billion, caused in addition to subsidized gas prices by payments for Russian gas supplied in 2013, rendering transit services prepaid in previous years, and significant Eurobonds and loans repayments. As Naftogaz turned profitable in 2016, the company stopped receiving share capital contribution support from the state. (Figure 2.3)

**Figure 2.3. State capital injections (domestic bonds), UAH billion**

As the company turned profitable in 2016 it stopped receiving share capital contributions.



Source: Naftogaz questionnaire response.

Its debt portfolio, as of year-end 2017, is made up entirely of bank loans (after its domestic bond issue of UAH 4.8 billion was repaid in 2017).<sup>62</sup> Given the challenges to raise capital cited further below, Naftogaz mainly borrows from state-owned financial institutions (Ukrzazbank, Ukreximbank and Oschadbank), making up 66% of its debt portfolio (not including subsidiary loans).

The remaining 34 % of its debt portfolio is raised through borrowing from international financial institutions (e.g., EBRD, IBRD etc.), whose funding usually requires state guarantee backing. Naftogaz' subsidiaries' loans (UGV and UTG) represent only 4% of the consolidated loan portfolio, 74% of which is current debt. The total outstanding balance for 2017 amounts to 59,315 million UAH. In 2017, state guarantees amounted to UAH 22,023 million UAH compared to UAH 28,912 million in 2016 (Figure 2.4). The average interest rate for all types of borrowing ranges from 18 % to 2 % depending on the currency denomination. (See also Naftogaz 2017 Annual Report)

**Table 2.3. 2017 Financial position: consolidated financial statement, in million UAH**

	2017	2016	Notes
Total non-current assets	508,014	568,140	Mainly from property, plant and equipment
Total current assets	215,110	131,990	
<b>TOTAL ASSETS</b>	<b>723,124</b>	<b>700,130</b>	
<b>TOTAL EQUITY</b>	<b>440,519</b>	<b>455,590</b>	
Total non-current liabilities	88,059	117,832	Mainly from deferred tax liabilities and borrowings
Total current liabilities	194,546	126,708	Mainly from advances received; provisions, borrowings
<b>TOTAL LIABILITIES</b>	<b>282,605</b>	<b>244,540</b>	
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>723,124</b>	<b>700,130</b>	

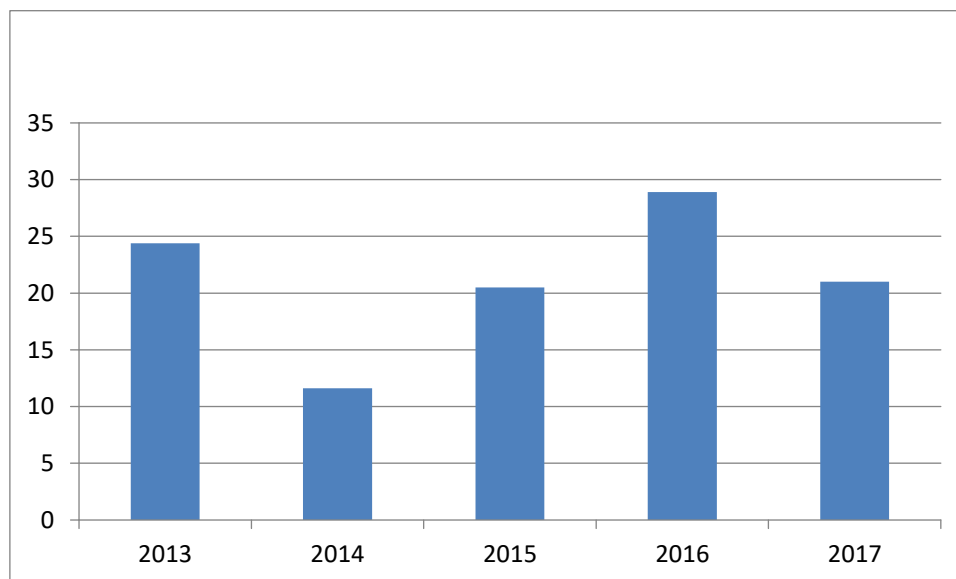
Source: Naftogaz annual report, 2017.

Some of the cited challenges by Naftogaz to raise capital include:

- *Requiring government approval to raise capital.* Naftogaz must get approval from the Ministry of Finance and the CMU to obtain loans, guarantees or sureties under a loan agreement. This requirement extends to both short and long term loans (i.e. over a year) as well as external or internal borrowing. The process remains administratively burdensome and relies on the government's own decision-making processes as guarantees can only be decided following the approval of the state budget. This creates uncertainty around sufficiency of the budget to cover all loan applications, and in 2018 it was reported that such guarantees were not available.
- *Prohibition of pledging assets as collateral or selling assets or shares of subsidiary companies.* Due to rather restrictive laws pertaining to "Pipeline Transport" Naftogaz is restricted from selling its assets or using them as collateral. The company's management report that there are only three types of collateral that the Company has at its disposal to use for attracting loans: (1) contract revenue of future periods; (2) goods in turnover; and (3) goods inventory.

It is worth noting that Naftogaz is one of a number of SOEs identified as being strategic and therefore the sale of shares is not possible unless the government and ultimately parliament approves the (partial) privatisation of the company.

**Figure 2.4. State guaranteed financing to Naftogaz, in billion UAH, balance as of end-year, in UAH billion**



Source: Naftogaz questionnaire response.

## Governance of Naftogaz

### *Background and context for corporate governance reform of Naftogaz*

As mentioned in section 1, in 2015 the government of Ukraine, with the support of EBRD, undertook an ambitious reform agenda to upgrade Naftogaz's corporate governance practices in line with the OECD Guidelines on Corporate Governance of SOEs (the "SOE Guidelines"). This reform was part of the Corporate Governance Action Plan or CGAP which was adopted by the Cabinet of Ministers of Ukraine (CMU Protocol Decision 112, and 117). The CGAP was integrated as part of a loan conditionality agreement with EBRD, which as noted above, is a creditor of the Government of Ukraine. The CGAP aimed to achieve the following:<sup>63</sup>

- assignment of the CMU as the owner of Naftogaz;
- clarify the corporate rights of Naftogaz in its subsidiaries;
- approval of ownership policy, key performance indicators and disclosure requirements for the supervisory board;<sup>64</sup>
- develop and submit for approval by the Parliament draft laws ensuring initial insulation from political meddling and graft in line with international standards;
- approval of new Charter of the Company;
- supervisory board appointment and board role;
- establishment of a system of internal control within Naftogaz and removal inefficient state controls; and,
- certain amendments to laws aimed at implementation of the reform, additional legislative initiatives.

CGAP was developed into a comprehensive roadmap for corporate governance reform that includes proposed amendments to laws and regulations with regard to governance of Naftogaz and the future independent operator of natural gas transmission system (i.e. MGU) (approved by the separate protocol decision of CMU<sup>65</sup>). Performance and status of the CGAP for Naftogaz has been monitored by a working group established in 2016 appointed by the government and chaired by the Vice-Prime Minister Volodymyr Kistion. At the end of 2017 the government assessed that the CGAP for Naftogaz had been achieved. However, at the time of this assessment there is disagreement between Naftogaz and the government as to whether the CGAP was fully achieved. According to Naftogaz, it was only partly achieved.

An overview of the impact of some of these reforms are provided in the following sections.

### *Legal and regulatory framework applicable to Naftogaz*

Given the legal system of Ukraine is transitioning, this also has an impact on the legal and regulatory framework applicable to SOEs. In the case of Naftogaz, the company and its subsidiaries existed under the Soviet system as state property, and were gradually corporatised or re-established under new legal forms following independence.

The process of incorporation has been carried out in a non-systematic way. As demonstrated by the case of Naftogaz, the company was established as a JSC even before the existence of relevant company or SOE-specific legislation. This piecemeal approach,

as well as the tendency to over-legislate/regulate the sector, has created a number of legal and regulatory frameworks that are inconsistent and even contradictory. According to the State Property Fund even SOEs incorporated under the JSC legal form "defer from ordinary corporate practice," as there are still ambiguities regarding titles to assets, determining whether company and private law or public sector laws apply; and determining the legal relationship between a parent company and its subsidiaries (where applicable).<sup>66</sup> (see also Box 2.1) In addition, scope of authorities of governing bodies does not comply with the legislation on joint-stock company (e.g. Supervisory boards under legislation on joint stock companies have much broader mandate).

### Box 2.1. Case study: Ownership of subsidiaries

#### **Attempt of the Ministry of Economic Development and Trade to modify the charter of Naftogaz effectively shifting ownership and control over Ukrtransgaz despite it being a subsidiary company**

In September 2016 the MEDT of Ukraine (in the capacity of Naftogaz Ownership entity at that time) had amended the Charter of Naftogaz and one of its subsidiaries (UTG). The amendments aimed to shift decision-making power with regard to the subsidiary company from Naftogaz, as the parent company, to the MEDT. It is reported by company management that such actions were politically driven. They also violated legislation and obligations under a number of contracts. In previously agreed loan and project agreements (for example with EBRD), amendments to charters of both Naftogaz and UTG should have been agreed with EBRD as the creditor. Thanks to joint actions of Naftogaz management and the supervisory board, EBRD and other relevant stakeholders, amendments to the Charters were annulled. Following which ownership responsibility for Naftogaz was transferred from the MEDT to the direct control of CMU.

*Source:* Naftogaz questionnaire response.

According to Naftogaz, the main applicable corporate, SOE-specific and sector-specific laws are as follows:

- Civil Code of Ukraine (2003), which provides for a general framework for all legal entities and civil relations in Ukraine;
- Commercial Code of Ukraine (2003) which provides for specific rules for business entities, including general framework for SOEs;
- Law on Management Objects of State Property (2006) (and various amendments) which is a special law applicable to SOEs.
- Law on Joint Stock Companies (2008);
- Law on Securities and Stock Market (2006);
- Law on Natural Gas Market (2015);
- Law on pipeline transport (1996); and
- Network Code approved by Resolution of the National Energy and Utilities Regulation Commission (2015).

Beyond these laws, various other institutions have issued regulations, procedures, and rules applicable to individual SOEs or to segments of SOEs, as well as to the sector more generally. This results in a complex web of overlapping and often contradictory legislation with regard to SOEs, Naftogaz not being an exception. It has contributed to the absence of clarity and visibility and can act to create opportunities for future potential political interference and corruption.

A state property reform strategy developed in cooperation with IMF and World Bank was approved in May 2015.<sup>67</sup> Unfortunately, the legislative framework is far from being complete, and a number of gaps and inconsistencies remain. The draft law 6428, which was registered with the Parliament in May 2017, included into the agenda in October 2017 and considered by the Parliament in March 2018 aimed to address some of these gaps, but at the time of this assessment it had yet to be approved. However, other notable changes were made to legislation with the intention of upgrading corporate governance practices in SOEs more generally, including law 1405 and 2210 (see Box 2.2).

### **Box 2.2. Upgrading SOE Corporate Governance Laws in Ukraine**

#### **Draft Law 6428 “On amendments to certain legal acts of Ukraine on improvement of corporate governance of the legal entities whose shareholder (founder, participant) is the state”**

This draft law is currently being considered by Parliament. It was registered in May 2017, discussed at session in March 2018 and has been sent back to relevant Parliamentary committees for further revisions.

The Law is considered to be an important step in demonstrating the willingness of the government to clarify inconsistencies with regard to existing laws, as well as to upgrade corporate governance practices in SOEs, notably through the empowerment of supervisory boards. The draft law, *inter alia*, would grant Supervisory Boards the rights to approve the strategic development plans, significant transactions (e.g., asset management agreements, joint-venture agreements, etc.), appoint CEO and Executive board members provided that this Supervisory Board authority is reflected in the SOE’s charter.

#### **Law 1405 on Amendments to Certain Legislative Acts of Ukraine Regarding the Management of Objects of State and Communal Property (2016)**

In 2016 the Ukrainian parliament adopted the “Law On Amendments to Certain Legislative Acts of Ukraine Regarding the Management of Objects of State and Communal Property” (Law 1405) followed by regulations adopted by the Cabinet of Ministers, which is considered a cornerstone of SOE corporate governance reform and was reportedly inspired from recommendations of the SOE Guidelines. The Law abolished voting instructions (except for certain cases),<sup>68</sup> requires each SOE to publish information concerning its strategic goals, quarterly and annual financial statements for the last three years, and (if applicable) budgeting of non-profit public policy objectives and sources of the funding of these, the annual reports, the charter, information regarding the members of the supervisory board and the CEO including their salaries, and the annual reports of the supervisory board and the reports of the external auditors, among other things.



**Law 2210 on Amendments to Certain Legislative Acts of Ukraine Regarding Improvement of Business Conduct and Attraction of Investments by Securities" (2017)**

In 2017, the "Law on Amendments to Certain Legislative Acts of Ukraine Regarding Improvement of Business Conduct and Attraction of Investments by Securities" (Law 2210) was adopted and became effective as of January 2018. This law aims to improve, inter alia, the functioning of the Supervisory Boards in both state and privately-owned joint-stock companies. Among its other newly-introduced provisions, the law requires public joint-stock companies to have independent Supervisory Board members and for the board to form mandatory committees (such as Remuneration, Appointment, and Audit Committees), and it extends Supervisory Board authority.

In addition, Law 2210 envisages additional requirements regarding disclosure of information by joint stock companies. It establishes new rules for compiling of regular reports, their scope (extended) and procedure of their approval.

Source: Questionnaire responses and draft text of the law.

***Corporate Charter of Naftogaz***

Up until the corporate governance reform of Naftogaz, the Charter of Naftogaz (i.e. CMU Resolution 747) was the subject of much debate. Since 1998, the said Charter was amended 30 times. All of these amendments mainly covered changes in the listing of assets contributed to (and extracted from) the share capital of Naftogaz.

The Current Charter and other corporate regulations of Naftogaz were approved by the CMU in December 2016. These other corporate regulations include:

- rules of Procedure for Supervisory Board; and,
- rules of Procedure for the Executive Board.

According to the current Charter, the CMU is registered as the body authorised to manage corporate rights of the state in the share capital of the company<sup>69</sup>. Its authorities, as envisaged by the Law of Ukraine "On Management of Objects of State Property", Law of Ukraine "On Joint Stock Companies", Law of Ukraine "On the Cabinet of Ministers of Ukraine", and Charter of the Company include, inter alia the competence regarding:

- Approval of Charters;
- Appointment of the Supervisory Board members and the CEO;
- Approval of strategic development, financial and investment plans;
- Ensuring annual independent audit of financial operations;
- Approval of joint activity, commission, and brokerage agreements; and,
- Ensuring allocation of part of profits.

It should be mentioned that the scope of the ownership entity in being involved in the day-to-day management of the company is quite large, and extends beyond practices supported by the SOE Guidelines and country best practices. As pointed out in section 1, contrary to commonly accepted corporate practices, currently the approval of the SOE's corporate strategy, annual financial plans, financial reporting, as well as of other decisions in regards to the economic activities of the SOE, does not fall within the exclusive competence of the

Supervisory Board. By law, the CMU approves financial plans of Naftogaz. Even the Supervisory Board of Naftogaz is not fully empowered to decide on CEO appointment and dismissal. As for the affairs of subsidiary companies, the company charter grants the Supervisory Board prior approval which is obligatory on a range of matters pertaining to subsidiary companies.<sup>70</sup>

The day-to-day involvement in the company in key areas such as being involved in approvals of financial plans etc., undermines the role of the executive management; and encroaches on the role of the Supervisory Board (e.g. to approval of strategy and budget, election and termination of authorities of executive body, approval of material transactions beyond certain thresholds or transactions of certain types, etc.). It also opens doors for *ad hoc* intervention by the state (discussed in more depth below).

At the time of writing a new draft of the Charter had been endorsed by the Supervisory Board in April 2018. It had yet to be approved by the CMU, with the main changes including increasing the delegation of power to the Supervisory Board (as it is currently defined) and clarifying the roles and responsibilities in view of the upgraded internal controls system put into place following CGAP reforms. Draft law 6428 also aimed to upgrade existing corporate governance practices, but until its adoption, the Government considers it must operate within the current legislative framework.

### **Box 2.3. Scope of amendments to draft Charter under consideration in 2018**

Key amendments proposed in this new Charter of the Company include:

- Amendments resulting from implementation of the System of internal control (SIC) within the Group aimed at abolishment of inefficient statutory controls<sup>71</sup>;
- Change of the Company's type from Public to Private joint stock company;
- Reflecting amendments due to new legislation effective from January 2018 (Law 2210);
- Establishing a definition of the Naftogaz Group;
- Changing the group's composition to make the Parent company at the corporate centre of Naftogaz exercising a "strategic controller" role<sup>72</sup>;
- Identify the main directions of the Company's activity to be set by the shareholder annually;
- Re-shaping the corporate governance model of the company, taking into account the two-tier structure;
- Change of the executive body from executive board to the CEO;
- Change in the approach to approval of transactions; and,
- Amendments to certain rules of procedure of the Supervisory Board.

Source: Naftogaz questionnaire response.

### *Governance bodies*

The JSC law calls for two-tier board requirements for all JSCs, including SOEs and is the case with Naftogaz. The two-tier system, which some observers posit resembles the German two-tier model, calls for a supervisory board and an executive board, essentially made of key members of the management team (but not all members). The JSC Law defines a Supervisory Board as “collegial body which protects the rights of the shareholders and within the competence that is defined by the charter, and this law manages the joint stock company as well as controls and regulates the activities of the executive body”.<sup>73</sup> Where the JSC law has a requirement for one-third of supervisory board members to be independent directors, for SOEs the law requires a majority of members to be independent directors. The actual roles and responsibilities of the board are further determined by the company Charter.

The topic of SOE board practices is an evolving one in Ukraine, as it is a relatively new concept both in terms of SOEs and in the corporate governance environment more broadly. Until 2016 with the corporate governance reform of Naftogaz, supervisory boards with independent directors did not exist in Ukrainian SOEs. This changed with the enactment of the Law 1405 which made the establishment of Supervisory Boards obligatory for SOEs (including unitary enterprises) meeting certain thresholds, and required that majority of boards members be independent directors. It also allowed for an independent board member, as opposed to a representative of the state, to hold the position of board chair (which was previously not the case).<sup>74</sup>

However, due to poor drafting language in Law 1405, additional challenges were introduced regarding the role of the two-tier board. The law vests supervisory bodies, with authorities that would normally fall under the remit of the executive board and sometimes confuse the roles of these two governing bodies. For example, recent amendments vest both the supervisory board and executive board with the authorities to “manage” the company. The law further defines the supervisory board as the “governing body”. As a result of this poorly drafted language, the supervisory board as the controlling body, which is separate from the executive board, has been overloaded with requirements to fulfil operational and managerial functions which would normally be vested with the management board. One example is that, internal risk management and control functions are fully attributed to the competence of supervisory board bypassing the executive board. According to Naftogaz, this leads to a gap in day-to-day management of these functions. Moreover, it burdens the supervisory board with tasks that hinder its ability to focus on high-level issues such as strategy setting, and ensuring that it oversees of management. Naftogaz is of the opinion that these ambiguities could be clarified through a Corporate Governance Code that would clarify the roles and responsibilities of the respective governing bodies.

### *Supervisory board*

Historically, the size, composition and level of independence of the Supervisory board has varied. Naftogaz used to have a Board composed solely of representatives of various government ministries that participated in the decision-making process within the boundaries of voting instructions issued by the government (ministry as then shareholder). Until the reform of its board in 2016, it was not uncommon that the board would have “technical meetings” only in instances where the Board’s engagement was required by the law and could not have been avoided.

Under the CGAP, these practices changed. In April 2016, for the first time a Board made up of a majority of independent directors was appointed. At that time the Board consisted

of five members: three of which were independent directors and two government representatives. In March 2017, the government adopted a decision to increase the number of the Supervisory Board members to seven, thus requiring appointment of another independent director and another government appointee. The government further defined the criteria for independence for the Naftogaz Board (see box 2.4).

This first independent board only served for a short time. By October 2017, three independent directors and one government appointee resigned (the circumstances for their resignations are discussed separately).<sup>75</sup> In December 2017, the government appointed four independent directors and two additional government appointees forming its new Supervisory Board. However, one of the independent directors appointed in December 2017 has not signed the service agreement nor attended any board meetings held to date.

**Table 2.4. Current Naftogaz Supervisory Board Composition and Committees**

From July 2018					
Position	Name	Audit and Risks Committee	Ethics and Unbundling Committee	Nomination and Remuneration Committee	Committee on Health, Safety, Environment and Reserves
Board Chair - Independent Director	Clare Mary Joan Spottiswoode	X	X		
Deputy Chair -State Representative	Volodymyr Vasylyovych Demchyshyn		X		X
Independent Director	Bruno Jean Gaston Lescoeur	X		X	X
Independent Director	Amos Hochstein		X	X	X
(Independent Director)	Steven John Haysom*				
State Representative	Sergii Dmytrovych Popyk			X	X
State Representative	Volodymyr Dmytrovych Kudrytskyi	X	X		

*Source:* Naftogaz Annual report 2017 and updates provided by Naftogaz.

*Note:* \*Steven John Haysom is currently not an active member of the supervisory board and has not signed a service agreement.

All Supervisory Board members were appointed directly by the shareholder, i.e. the Cabinet of Ministers of Ukraine. Although Ukraine has established a selection commission and nomination committee under the CMU aimed with professionalising the Board nomination process (see more under “State as Owner”), this particular Board was selected under an accelerated process, as the government was reportedly under pressure from the creditor community to appoint a new Board quickly. However, the Board was selected based on merit and candidates were selected based on input from international financial institutions and the broader international community which have taken an interest in the reform of Naftogaz. Moreover, the independent directors fulfilled the criteria for independence identified by the Law on Joint Stock Companies (Article 2) and the Law on Management of State Property Objects (article 11).

#### *Supervisory board responsibilities*

Contrary to commonly accepted good corporate practices, currently the approval of Naftogaz’s corporate strategy, annual financial plans, financial reporting, as well as of other

decisions in regards to the economic activities of the SOE, do not fall within the exclusive competence of the Supervisory Board. By law, the CMU approves financial plans of all SOEs which are natural monopolies and those SOEs for which planned net profit exceeds UAH 50 million. In other cases, this falls within the competence of ownership entities, which in this case would also be the CMU.

Supervisory Boards of SOEs are not empowered to decide on CEO appointment and dismissal; but in some cases the company charter gives the Board "preliminary approval" on a range of issues and the right to give "recommendations". (See Table 2.5).

**Table 2.5. Responsibilities of boards of directors of Naftogaz**

	Shareholding ministry	Supervisory Board	Executive Board (chaired by CEO)
Approve enterprise strategy	Y	N	N
Appoint and dismiss the CEO	Y	N	N
Approve corporate transactions beyond a certain threshold	Y	Y	Y

Source: Questionnaire responses.

Other Supervisory Board functions inter alia include the assessment and monitoring of the management's performance, the creation of an internal audit function and the approval of the procedure for internal audit as well as the approval of company's regulations regarding anti-corruption, business ethics, and corporate social responsibility. These specific responsibilities are outlined in the company charter (Annex A).

#### *Supervisory board committees*

The Law of Ukraine "On Joint Stock Companies" and CMU Resolution 142 require that at least two committees (audit committee and nomination and remuneration committee) are put into place and that these committees are chaired by an independent director.<sup>76</sup> In the case of Naftogaz the company has four committees, each chaired by an independent director (see Table 2.4) these include:

- Audit and Risks Committee;
- Ethics and Unbundling Committee;
- Nomination and Remuneration Committee; and,
- Committee on Health, Safety, Environment and Reserves.

It should be noted that the most recent amendments to the Law on Joint Stock Companies call for the nomination committee of the Board to be in charge of developing its own succession plan and recommend to the shareholders, via the annual general meeting, future Supervisory Board candidates. However, in actual practice the nomination of future Supervisory Board members and CEOs of economically important SOEs would go through established inter-ministerial nomination committee.

#### *Supervisory board independence*

The independence requirements to members of Supervisory Boards are defined in a number of legal acts, including the Law on Joint Stock Companies, the Law on Management of State Property Objects, and resolutions of the Cabinet of Ministers applicable to SOEs.

Notably, CMU Resolution 142 includes stipulations on the qualifications for independent members of the Supervisory Boards (see Box 2.4.). Supervisory Boards of SOEs should be composed of a majority of independent members (i.e. 4 members in case of Naftogaz), as well as representatives of the state which are appointed by the relevant state authority (i.e. 3 members in the case of Naftogaz).

However, as mentioned earlier due to the non-acceptance of a board position by an independent supervisory board member, the composition of the current board does not assure that a majority of members are independent.

#### **Box 2.4. Criteria for "Independent Director" for the Naftogaz Board**

The Cabinet of Ministers of Ukraine adopted the shareholder resolution regarding certain matters of establishment of the Supervisory Board of Naftogaz, which includes principles of formation of the Company's Supervisory Board. These include independence, professionalism, competency, diversity, effectiveness and transparency.<sup>77</sup> The resolution defines independence as persons who do not hold elective positions and are not officers of the state and/or local governments and are free from any material interest or relationship with the Company in its management, which may endanger their objective judgement.

This resolution specifies that independent directors of the Naftogaz Supervisory Board must meet independence criteria established by the legislation. Furthermore, the current Rules of Procedure of the Supervisory Board of Naftogaz also includes specific independence criteria that apply to independent directors of the Company.

Source: CMU Resolution 232<sup>78</sup>. See also Rules of Procedure of Naftogaz Supervisory Board.

#### *Supervisory board liabilities*

According to the JSC law, the statutory obligation of joint stock company officers, including members of the Supervisory Board to act in the interests of the company is developed in the current Charter of the Company establishing that the Supervisory Board member shall act in the interests of the Company and not in the interests of a person or body which nominated, approved or appointed them (this point is also reinforced in the "service agreements" with individual Board members). In addition to this, the Rules of Procedure of the Supervisory Board obliges Supervisory Board members to act in good faith and reasonably and in the interests of the company and not exceed their powers.

It should be noted that the concept of fiduciary duties is not well developed in Ukraine and there is no established practice of its implementation. The legal framework builds the requirement around the duty of care and duty to act in the interests of the Company. The Supervisory Board members, who are defined as officers of a joint stock company are liable for the company's damages arising from their improper action or inaction and if damages are caused by a number of persons they can be held liable jointly. The Supervisory Board members are generally subject to civil or criminal liability as established by the law.<sup>79</sup>

In addition to this, according to the recent changes in Ukrainian law a shareholder with at least 10% of shares is entitled to file a derivative suit on behalf of a company against its officers (e.g., the CEO or Supervisory Board members, who also fall into the definition of the officers of a joint stock company) claiming damage caused by their actions or inactions,

subject to specific requirements. However, there is no established court practice of implementation of these provisions engaging members of Supervisory Boards in particular.

The law and regulations provide for the following duties of the Supervisory Board members and they are generally identical to those applicable in the private sector:

- duty of loyalty (to act in the interest of the Company, in good faith and reasonably);
- duty to act within powers (to comply with the law and the charter and other internal regulations of the company);
- duty to provide information to shareholders, revision commission and auditors;
- duty to declare conflict of interests and reimburse damages;
- duty of confidentiality; and
- anti-corruption duties.

Subject to amendments introduced in to the Law on Prevention of Corruption in 2017, Board members of SOEs are now required to submit annual declarations of assets in their ownership (i.e. "e-declaration"). Candidates for such positions are also required to submit declarations. Administrative and criminal liability can be imposed in case of violation of this requirement. Previously, this requirement only concerned the management and other personnel of the SOEs.<sup>80</sup> This requirement applies to both Ukrainian and foreign nationals. It has caused much controversy, including from G7 Ambassadors, who urged the Ukrainian Parliament to cancel the requirement due to its apparent violation with international commitments and laws, as well as the risk that it deters Ukraine from the recruitment and retention of qualified international supervisory board members.<sup>81</sup> Despite an appeal to Parliament by the government, amendments to the law have not been repealed and at the time of writing it appeared that for most major SOEs, including Naftogaz, the majority of independent directors that have been appointed were not in compliance with this requirement due to the onerous requirements (both in substance and in form)<sup>82</sup>.

### *Executive board and other key management*

Current Executive Board of the Company consists of six members: Chairman, First Deputy Chairman, Deputy Chairman, and three members, including two CEOs of key Naftogaz Group companies. CEOs of key Naftogaz subsidiary companies may not vote on the matters as regards the respective subsidiary company that are within the exclusive competence of the Supervisory Board pursuant to the law.

The Executive Board is the collegial executive body of the Company responsible for the governance of the Company's day-to-day affairs. According to the law, the executive body is authorized to make decisions on all matters of a joint stock company except for those reserved to the General Meeting or Supervisory Board (see Annex B). The Executive Board is considered to have a limited range of powers, as the prior approval of the Supervisory Board or shareholder for operational issues is often required by law (and Charter).

As for the appointment of the CEO and Executive Board members, the CMU is the competent authority, although appointment by the Supervisory Board is one of the cornerstones of the corporate governance reform envisaged by the CGAP. The respective amendments to legislation regarding this point were included into Draft Law 6428.

The Executive Board member cannot be the Supervisory Board member at the same time. New Executive Board members should meet the requirements set by the Nomination and

Remuneration Committee of the Supervisory Board. It should also be mentioned that due to reasons unknown to the assessment team key members of the management team are not part of the Executive Board.

### *Challenges related to governing bodies in Naftogaz*

Despite recent efforts to empower Supervisory Boards, recent legislative changes intended to upgrade corporate governance practices, have had some unintended effects. They have reportedly bogged down the Supervisory Board with decisions related to operational and management functions, which would traditionally fall under the competence of the Executive Board in a more "traditional" two-tier system. By some accounts, these changes have stripped the Executive Board of certain key functions such as monitoring internal risk management and control functions. To further complicate matters, as discussed, current legislation in Ukraine empowers the state as shareholder to be involved in the day-to-day management of the company, infringing on the roles assigned to the governing bodies of the company.

Moreover key functions that should belong to the Supervisory Board, such as the competence to appoint/remove the CEO, approve the corporate strategy, financial and investment plans still remain with the state as a shareholder. The Government planned to change some of these practices by further empowering supervisory boards with the introduction of Draft Law 6428 (pending in Parliament since October 2017). It should be noted that, while waiting for the outcomes of the Draft Law the amendments to the Charter proposed by the Executive Board and endorsed by the Supervisory Board would provide some of these authorities to the Supervisory Board.

### *Governance of subsidiaries*

For subsidiary companies falling under "*Category 1 - Subsidiary companies established by Naftogaz*" Resolutions of the Company's Executive Board serve as decisions of the highest governing body and are binding for executive bodies of the respective companies.

For subsidiary companies falling under "*Category 2 - 100% owned Business companies*" the Shareholder resolutions of such companies are based on resolutions of the Company's Executive Board. Under the current Company's Charter certain matters related to the wholly owned business companies require preliminary approval of the Supervisory Board, such as amendments to their charters, reorganization and liquidation, changes in share capital, election and termination of authorities of their CEOs, approval of Executive Board members in case of dispute concerning nominees between the CEOs of Naftogaz and the respective company, suspension of their CEOs and appointment of acting CEOs, approval of contracts with their CEOs and setting of remuneration, approval of their strategy, financial plans, business plans and investment plans, approval of Regulations on their GSMs and on their Executive Boards, and approval of certain transactions.

For companies falling under "*Category 3 - Partly owned Business companies*" representatives of the Company participate in governing bodies of such companies according to voting instructions that are executed on the basis of the respective resolutions of the Company's Executive Board

### *Establishing a system of internal controls*

Under the CGAP Naftogaz was required to establish a system of internal controls which it developed with the assistance of international consultants. The system established key



controlling functions including financial control, risk management, compliance and internal audit in Naftogaz and its subsidiary companies. It also established a number of key documents including the company's policy on internal controls; Regulations on Compliance, Risk Management, Internal Audit, Financial Control and appointed heads of the respective functions. It further established a Compliance Program underpinned by a compliance risk management policy; a Code of Ethics, an Anticorruption program with a whistleblowing system; and a Policy on Conflict of Interests. In the area of risk management, a full programme was established including a Risk Management Methodology, with Rules on risk management interaction within Naftogaz, and its investment policy.<sup>83</sup>

According to the company's management, the controls system was implemented and started functioning in Q4 2017. The CGAP required obtaining the opinion of an independent expert which was obtained. This was a pre-requisite to remove some of the inefficient state controls (discussed below) and envisaged under CMU Resolution 899. This means that with the implementation of its system of controls it is no longer prohibited to spend funds on capital investments, purchase and lease of auto cars, marketing and consulting services, insurance, hospitality, advertising, charity, etc. in case financial plan is not approved by the CMU.

This is an important step forward as it allows the company to run its business without being in violation of the CMU resolution, especially in the absence of timely reply from the CMU on the approval of its financial plans, which are often delayed for approval until in November or December of the same year (it should be noted that according to the CMU Naftogaz has submitted its financial plans with delays, which complicates timely analysis of the documents). Moreover, the semi-centralized and the centralized functions of internal control at the Group level imply extended rights over subsidiaries in order to ensure more effective group control.

***Unfortunately as of 18 September 2018, the amendment of CMU Resolution 899 restored its application for Naftogaz. Remuneration***

The remuneration of Supervisory Board members as well as SOE executives is regulated by the Cabinet of Ministers. Although remuneration levels for both categories are capped, recent amendments to the relevant CMU resolutions have aligned remuneration practices with net profits, as opposed to the number of employees as it had been prior to the reforms. As mentioned, the issue of board and executive remuneration continues to be a contentious policy issue in Ukraine and has caused considerable controversy.

In the case of Naftogaz the level of remuneration for individual independent directors has been set at UAH 6,328,000 (gross) annually and 75% of that amount for government appointees. The Board chair and participation in individual board committees allows for supplementary remuneration. In the case of the former this amounts to 20% of total remuneration; and in the case of the latter 10% of the remuneration. Compensation of expenses incurred during performance of Board member functions is counted separately.

***Transparency and financial and non-financial disclosure***

Corporate governance requirements, including on reporting and disclosure, are still evolving in Ukraine. Until recently most SOEs were not required by law to produce audited financial statements. This changed in 2016 with CMU Resolution 1067. Subject to this resolution, SOEs regardless of their corporate form or size, and where the state owns more than 50% of the shares of the company, are required to disclose:

- Quarterly financial statements (including consolidated) for the last 3 years, including (if available) expenses for non-commercial targets of the state policy and sources of their funding (not later than on the last day of the month following the reporting quarter);
- Annual financial statements (including consolidated) for previous 3 years, including (if available) expenses for non-commercial targets of the state policy and sources of their funding (not later than on 30 April of the year following the reporting);
- Audit opinions on annual financial statements for the last 3 years in case the audit was conducted pursuant to law or resolution of the Supervisory Board (if formed), or in the absence of a Supervisory Board, another body authorized to govern corporate rights of the state.

As is the case with Naftogaz, large SOEs<sup>84</sup> are required to have their financial statements made according to International Financial Reporting Standards and audited by internationally recognised audit firms and in accordance with the International Auditing Standards. It should be noted that Naftogaz was among the few large companies in Ukraine, state-owned or private, that has been subject to enhanced transparency and disclosure practices prior to the CMU resolution. Qualifying Naftogaz subsidiaries are also subject to fulfilling transparency and disclosure requirements separate from the group, as per this resolution.<sup>85</sup>

Naftogaz is among the few SOEs in Ukraine that also has a practice of disclosing non-financial information, which is for it and more generally for the SOE sector given the substantial public service obligations they carry out, as well as the number of stakeholders involved. In the case of Naftogaz, its comprehensive annual reports published as of 2015 include comprehensive information on corporate governance.

### The State as owner of Naftogaz

As mentioned earlier the CGAP reform moved the exercise of ownership rights of Naftogaz from the MEDT to the CMU. In principle this was considered a step in the right direction by stakeholders, and in particular by Naftogaz, as it would represent a more whole-of-government ownership of the company and potentially shield it from undue future potential political interference or excessive intervention by individual line ministries intervening through various mechanisms in the company's operations. However, this change in the exercise of ownership rights only appears to be in name and not in practice. While the CMU is the sole authority authorized to manage corporate rights of the state (ownership entity) for the Company, many of the ownership functions are initiated by the Ministry of Economic Development and Trade of Ukraine, pursuant to the current Charter draft resolutions of the CMU should be developed and motioned by the MEDT, and often in consultation with other government departments. The issue with this process is that it results in lengthy approvals processes, it poses the risk of “watering down” decision making and subjecting it to potential opportunities for future potential excessive intervention; while also being potentially duplicative.

As indicated earlier in this report, overall the authorised entities responsible for state ownership lack the capacities to exercise ownership as recommended by best practices. Moreover, as in the case of the CMU, fulfil multiple and competing objectives. The additional powers given to the state as a shareholder undermines the role of its governing

bodies and allows for the intrusive involvement in the day-to-day management of the company.

### ***Ownership policy and rationales***

The government of Ukraine approved on 10 October 2018 a basic ownership policy under the leadership of the MEDT, which is called "Basic principles - introduction of ownership policy for state-owned enterprises".

The "Basic principles" covers the following themes: the state ownership must be justified, the objectives of the enterprises are to be defined, a level playing field shall be maintained between private and state-owned entities, the regulatory duties of state bodies are to be separated from ownership, appointment of Supervisory Board members and of top management must be transparent and skill-based, the reporting by the enterprises must be full and transparent, and the entities shall bear the social responsibility in their operations. According to the Principles, ownership entities having ownership rights in enterprises of particular importance, i.e. assets exceeding UAH 2 billion or net annual revenue exceeding UAH 1.5 billion, should draft company-specific "ownership policies" (i.e. company-specific ownership expectations) regarding these particular enterprises.

In the case of Naftogaz, the CMU has developed a short company-specific set of ownership expectations (also called "ownership policy" in Ukraine), which outlines the main rationales for ownership of Naftogaz. However, the company management reports the ownership policy fails to give the owner's vision for the company and sector in which it operates. Moreover, it does not provide adequate guidance for the company's governing bodies to make informed decisions based on a clear set of owner's expectations.

### ***Public policy objectives***

Public policy objectives for Naftogaz are officially set by CMU as the ownership entity. However, given that many public policy objectives are linked to the sector of activities in which the company is run these can be mandated through constitutional obligations; laws; resolutions; amendments to laws and resolutions; as well as a plethora of orders, decrees, decisions and other similar governmental regulatory and court rulings that are enacted by various government authorities including the Cabinet of Ministers, all the way down to line ministries and regulatory authorities.

Given that the lines of responsibilities with regard to SOEs, in general, are blurred between various government authorities, there is no one authority that clearly sets commercial and policy objectives for an individual SOE or sector. Special laws for certain sectors exist for example in the railways and utilities, in the energy sector as well as in other strategic areas. One would generally expect that any sectorial public service obligations would be set by a line ministry, based on an overarching governmental strategy and then supervised/enforced by an independent regulator, but there are many exceptions to the rule. These exceptions relate to who actually sets the public service obligations and the level of independence of the regulator.

In the energy sector it is the Cabinet of Ministers and not the energy regulatory authority (NCSREPU) that mandates the supply of gas to Ukrainian households at below-market prices. And although gas tariffs are set by the NCSREPU, its independence as regulator can be considered questionable as its budget and staff are determined by Presidential decree, which empowers the President to appoint and dismiss the regulator's Chairperson and six

commissioners<sup>86</sup>, as well as determine the number of staff and budget the Commission can have (EC, 2018).

It should be noted that public policy objectives for Naftogaz are apparently not in line with (or sometimes in direct conflict with) other objectives set by the Government towards individual SOE. The areas of conflict include its dividend policy; its commercial objectives; or even in terms of broader commitments towards international partners with regard to market liberalisation.

#### Box 2.5. Case studies of public policy objectives in Naftogaz

- **The CMU obliged UGV (100% subsidiary company of Naftogaz) to supply fuel to Ukrzaliznytsia:** In February 2015, the CMU obliged Ukrgasvydobuvannya (a joint stock company wholly-owned by Naftogaz) to provide fuel to Ukrzaliznytsia (state-owned railway company). The fuel was provided as part of an interest-free lease. The respective resolution was executed in the form of a “protocol decision” which is not publicly available. Later in August 2015, the CMU adopted Ordinance imposing the similar obligations on UGV.
- **The CMU obliged Naftogaz to supply gas to Odessa Port Plant:** In September 2016, the CMU obliged Naftogaz to supply gas to Odessa Port Plant (irrespective of the latter’s debts owed to Naftogaz) up until 31 December 2016 (the respective obligations were included into PSO imposed upon Naftogaz by CMU Resolution dated 22 September 2016 No. 658). On 28 December 2016, the CMU issued Ordinance No. 1018-p, whereby the debt of Odessa Port Plant owed to Naftogaz was restructured for two years starting from 1 April 2017 (interest-free).

Source: Naftogaz questionnaire responses and various public sources and records.

#### *Financing public policy objectives*

In Ukraine, public policy objectives are financed through (indirect) subsidies. However, they are not well-targeted and tend to be negotiated without clear prioritisation during the budget preparation process. The process starts via line ministries which are responsible for the formulation of requests for budget subsidies in the sectors for which they manage and oversee SOEs. Initial subsidy requests are then discussed with the Ministry of Finance and final decisions on the amount of the subsidy to be included in the budget are made. These decisions take into consideration the financial envelope of the budget and the related financing constraints. As demonstrated further through the case study of Naftogaz, the process does not ensure that resources are allocated to meet policy objectives and subsidies tend to reflect a combination of factors, including historical support levels, estimated losses in SOEs, and other cost dynamics in SOEs (IMF, 2017). Moreover, the decisions are often impacted by political considerations and electoral cycles. Importantly, these decisions do not aim at maximizing the value of gas assets, long-term increase of total return to the State as the shareholder of Naftogaz, Company’s opportunity cost of capital and growth opportunities.

Often subsidies are continued without any real assessment of the fiscal risks that they pose. As mentioned earlier, the staggering amount of public debt and poor performance of SOEs

is partly a reflection of this reality. Resources are used towards unviable subsidy programmes, and to support loss-making SOEs. The sector in which this is most evident is energy. For years, electricity, gas and heat tariffs for households have been kept frozen as per government orders, despite increasing international prices and production costs of utility suppliers. Instead of subsidising the targeted populations directly, the government has mandated the SOEs to supply households at below market prices, and has developed a plethora of support measures to compensate for the resulting losses. Unfortunately, for SOEs the levels of subsidies were not sufficient to cover funding gaps or siphoned off through a system of opaque procurement or transfer-pricing schemes. As a result, there is significant short-term pressure on the budget to cover the funding gaps that emerge during the year, or they generate unfunded liabilities on SOE balance sheets. (IMF, 2017, OECD, 2018)

SOEs have tried to remedy these funding gaps through cross-subsidisation from profit-making to loss-making activities (as in the case of Naftogaz it subsidises its gas sales and supply business with income from the gas transit business), which although not inconsistent with competitively neutral practices, can result in a lack of transparency around the cost of public service obligations, and shift the cost burden to other lines of business and consumers which have an impact on overall competitiveness. Moreover, without a lack of clearly defined public service obligations for most SOEs and the contingent liabilities that can arise from funding them, defining a long-term commercial strategy or investment decisions remain impossible for most SOEs (Boytsun, 2015).

### *Development of strategic policy and development documents for Naftogaz*

As well as exercising ownership rights in Naftogaz, the CMU is responsible for the development of strategic policy and development documents related to the oil and gas sector. In 2016, CMU endorsed the policy document “The Concept of Natural Gas Production Industry Development until 2020 and approved the corresponding action plan. This document had been developed with high involvement of Naftogaz and had incorporated Naftogaz’ internal plan for growing its natural gas production volume to 20 billion cubic meters by 2020 and specifically spells the planned natural gas production volume for Naftogaz’ subsidiary UGV. The action plan however has only ministries and other state authorities as responsible parties. The objectives set for Naftogaz in the Concept were further included into the State Ownership Policy (CMU Resolution 351 as of 26 April 2017) called “On Approval of Key Foundations of Exercising the State Ownership towards Public Joint Stock Company “National Joint-Stock Company “Naftogaz of Ukraine”).

However, as mentioned above, the CMU-endorsed overall Energy Strategy of Ukraine, which sets forth state policies and annual targets for the country’s energy sector, fails to mention Naftogaz or its subsidiary companies and does not assign any objectives or actions for Naftogaz. The company-specific ownership expectations, called the “State Ownership Policy for Naftogaz,” does not have any references to the Energy Strategy either. The actual state ownership policy for Naftogaz is a two-page document which lacks the necessary detail to empower the company to set specific strategic objectives. It was drafted by the government in the absence of an approved Corporate Strategy; moreover it duplicates generic provisions of the company’s Charter rather than establishing a set of measurable performance indicators for the company.

At the time of writing the CMU sent a letter to the Board of Naftogaz with a series of draft “owners’ expectations”. However, this is complicated by a lack of regular and consistent dialogue between the owner and the board

### *Performance of Naftogaz-specific goal-setting activities*

In July 2017, the CMU has set the key performance objectives for the Supervisory Board<sup>87</sup>. The company reports that one of the key challenges is that there is a lack of formal process of engagement of Naftogaz into their development. In this case, the direct or indirect objectives set out in the documents have not been agreed upon (as well as the action plan needed to achieve them) and there is no formal process for agreement. As mentioned earlier in the report, the review and evaluation of the company relies on a basic system of grading. For 2016, the Supervisory Board and the Executive Board were graded as "conditionally satisfactory", while no explanation on the criteria of evaluation, key factors taken into account for the assessment, definition of the evaluation or recommendations were provided. In the absence of overall corporate objectives this performance evaluation process is only a formality.

### *Review and endorsement of Corporate Strategy, long-term investment plans and financial plans of Naftogaz and its subsidiaries*

The CMU also reviews and approves the Corporate Strategy and financial plans (together with long-term investment plans). As mentioned earlier in the document, the Corporate Strategy of Naftogaz has been developed in 2017, endorsed by the Supervisory Board and submitted for review and approval to the CMU in July 2017. It was brought to the attention of the assessment team that the CMU has not yet approved the Strategy at the time of this writing. According to the company, the non-approval of the Corporate Strategy complicates priority setting, business planning and performance management of Naftogaz' management.

The review and approval of financial plans by the CMU has a history of delays. The track record of timing for approval of Naftogaz financial plans is the following: 24 December 2014 – for the 2014 financial plan, 23 December 2015 – for 2015 financial plan, 11 November 2016 – for 2016 financial plan. The plan for the year of 2017 was approved in mid-2017.<sup>88</sup> Importantly, the financial plans of Naftogaz and its subsidiary companies are not reviewed simultaneously creating situations when the plan for Naftogaz might be approved but the respective plans for the subsidiaries might not. For example, for UGV, the 2014, 2015 and 2017 financial plans were not approved and 2016 financial plan was approved on 30 November 2016.

Moreover, the financial plan development and alignment process is not formalized and does not assume any alignment prior to submission, opening the door for return of the financial plan drafts for edits even in the case of minor changes. Such situations with financial plan approvals creates high uncertainty and impedes decision-making, especially with regard to capital expenditure, by Naftogaz and its subsidiaries, since incurring expenditure without approved financial plan may carry risks of investigations and potential criminal liability for management.

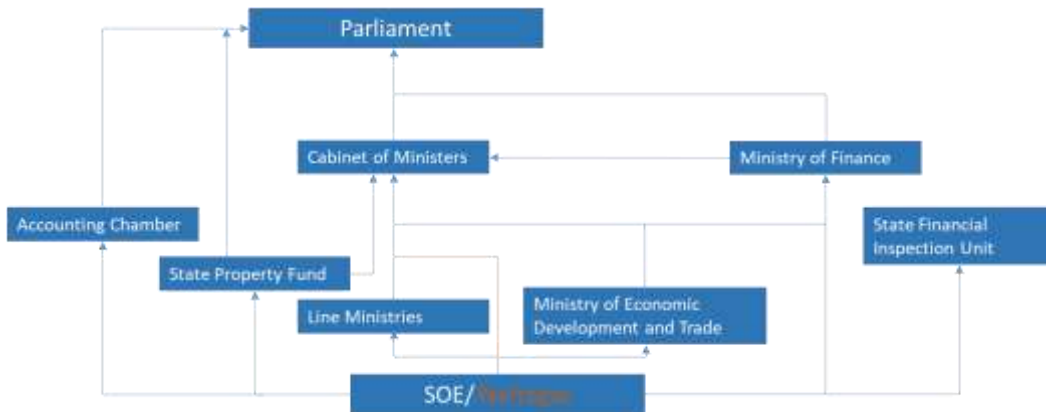
### *Accountability and state audit*

In terms of institutional accountability, Naftogaz, similar to other SOEs, has a rather burdensome and heavy reporting process vis-à-vis different public institutions, which they cite as a major disadvantage compared to their private competitors. This is an outcome of unclear lines of responsibility for the management and oversight. Some public institutions, such as the State Audit Units - which sit directly inside SOEs - are an example of how the public administration is often involved in day-to-day management of SOEs. A recent CMU resolution 639 which took effect from August 30, 2018 has abolished such requirements,

although the status of its implementation is not known. The table below provides an overview of the reporting lines of Naftogaz towards various institutions in the public administration with additional explanation of the individual role of some of these institutions outlined below.

**Figure 2.5. Flow of information disclosure between SOEs and the government**

SOEs are obliged to report to various state bodies, ranging from the shareholding entity and the MEDT, to a large number of state-audit/control bodies. The final recipient of information is the Parliament.



Source: Adapted from IMF, 2016.

### *Parliament (Verkhovna Rada)*

The Parliament is involved in various aspects of policy making and oversight of the SOE sector through its various committees. The main Parliamentary committees relevant to Naftogaz are the Economic Policy Committee and the Energy Policy Committee. The Parliament receives reports from the Supreme Audit Institutions on audits of the sector. It can convene ownership entities and representatives of individual SOEs for parliamentary inquiries. This process has its limitations as the legal framework does not emphasise the role of the legislature in accountability and scrutiny on behalf of the state owner.

### *Accounting Chamber*

The Accounting Chamber, which is Ukraine's Supreme Audit Institution, reports directly to the Parliament, and conducts state audits of the SOE sector (the frequency and intervals of such audits is not known). In December 2017, it had a focused review of the management of SOEs as performed by the MEDT and the SPF (see Box 2.6).

### Box 2.6. 2017 Report of the Accounting Chamber on SOEs

The Report of the Accounting Chamber in December 2017 concluded that a number of SOEs fail to report on their performance to their ownership entity and as a result their performance cannot be evaluated. Where performance has been evaluated the quality was criticized, lacking proper economic and financial analysis. Moreover, such analyses failed to inform future decision making vis-à-vis the SOEs.

For those line ministers reporting on their respective SOE portfolios to the MEDT, the information is incomplete and also lacks quality. The MEDT is, according to the report, unable to conduct an in-depth analysis in view of analyzing the broader sector. The report pointed out that in 2017 only 23 ownership entities (out of 85) have been effective in the oversight of SOEs in their portfolio. Finally, reporting by the MEDT to the CMU has, in the opinion of the Accounting Chamber, only served a "formal purpose" without an impact on policy, nor strategic or management decisions regarding SOE governance. For example, MEDT recommendations to the CMU lacked any reference to improving reporting and disclosure, despite the reporting shortcomings observed by the MEDT.

Source: OECD, 2018a.

#### *The State Audit Service (State Financial Inspection Unit)*

The State Audit Service of Ukraine (SAS)<sup>89</sup> is a central executive authority under the CMU which conducts public financial control. Its powers, to some extent duplicate those of the Accounting Chamber, but also go far beyond controls any "typical" state audit function would perform.

With physical offices in Naftogaz and all its subsidiaries, the SAS is involved in the day-to-day management of the company's operations, and is effectively duplicating the aforementioned systems of internal controls.

The SAS has powers to verify and sign all contracts and payments exceeding UAH 100 000 for goods and UAH 1 million for services. Among its roles it is involved in public procurement and conducts various inspections. It verifies adherence to accounting laws, accuracy of financial reporting and efficiency of internal audit functions of Naftogaz. It also has very broad sanctioning powers. For example, it can require the Naftogaz or subsidiary company CEOs to abide by its opinions and can file motions against the management in courts on behalf of the State, directly apply administrative fines to SOEs and refer its findings to law enforcement; it can also freeze state budget support to SOEs; and can annul signed contracts.

A recent OECD anti-corruption monitoring (OECD, 2018a) has found that its role has had perverse outcomes and created opportunities for corrupt arrangements. According to the law enforcement officials interviewed in the context of the monitoring it was reported that auditors of the SAS are suspected of "blackmailing SOEs" and that these auditors were perceived to be the "number one scare of the SOEs management." (OECD, 2018a)

It should be noted that a CMU resolution 639 effective from August 30, 2018 has abolished such requirements, although the status of its implementation is not known.



### ***Dividend policy***

Pursuant to the Law of Ukraine *On Management of Objects of State Property*, fully and majority state-owned companies (more than 50% of shares owned by the state), are required to pay dividends to the state budget and in the amount defined by the CMU each year, but not less than 30% of net profit of the reporting period.<sup>90</sup> Contrary to best practice, the dividend rate is not based on an individual enterprise's performance and objectives, but on a flat rate expressed as lump-sum value established by the CMU. For example, the dividend rate established by the state for SOEs in 2014 and 2016 was set at 50%; in 2015 and 2017 it was set at 75%. In 2017, this amount paid in dividends to the state by Naftogaz represented UAH 13.3 billion.

SOEs, including Naftogaz, consider the dividend policy to be arbitrary, and one that does not correspond to actual ex-post profit realisation nor the overall financial position of the company. Without an SOE-specific approach, the current policy can lead to the SOE becoming undercapitalized. According to calculations by IMF (IMF, 2017), dividends from public enterprises to the consolidated government budget have declined steadily in recent years and reached a meagre UAH 3.4 billion in 2014, in comparison to face-value assets of UAH 870 billion in SOEs. The same study has found that the return on these assets in the form of profits for the company and related non-tax revenue for the budget underperforms various benchmarks, including the economic growth rate of the last decade and the cost of borrowing for the state. (IMF, 2017)

A separate but related issue is the payments of dividends from partly-owned subsidiaries of which more than 50% shares are owned by wholly state-owned SOEs that are the parent company. According to recent practice in Ukraine these payments have gone directly from the partly-owned subsidiary SOEs directly to the state, as opposed to via the parent company which in turn would pay dividends to the state budget from net profit, calculated on the basis of consolidated statements. Naftogaz has considered this to be punitive as it essentially represents a double dividend. Moreover the legality of such practice can be put into question especially considering that the management and supervisory board should be held responsible for the payment of such dividends. This practice effectively strips the parent company executive management and supervisory board from those responsibilities. An attempt to rectify this issue was made in a recent draft law (draft law 6428, see box 2.2) but at the time of this report the law has not yet been passed and thus the problem has not been resolved.<sup>91</sup>

### ***Board nomination and appointment***

A CMU resolution from 2018 has made it a requirement that SOE board nominations (as well as for CEO positions) go through an inter-ministerial nomination process which aims that candidates are vetted widely, and it is coordinated at the CMU level. Candidates are identified by a headhunting company which proposes names for the shortlist of pre-selected candidates. This nomination committee comprises of 8 representatives of governmental ministries, as well as representatives from international financial institutions (Box 2.7). The nomination committee has recently been strengthened with additional capacity. This new system is a welcomed development to professionalise the board nomination process, while ensuring that suitable candidates, with the right skill sets and level of independence are identified. Although it has only been in place for a few months at the time of writing this report, in the few cases that it has been used, it appears, that the procedures have been respected and suitable candidates have been identified. Only time will tell whether the process can be safeguarded from potential future political influence.

### Box 2.7. Board and CEO inter-governmental nomination committee

According to the Law On Management of State-Owned Assets, the CMU approves the procedure for the competitive recruitment of Supervisory Board Members and CEOs for SOEs. The announcement of the competitive selection is made based on a resolution issued by the relevant ownership entity and it includes a deadline for applications and timing of the final decision. This resolution should be issued within 10 days after the vacancy for the position is opened.

A separate procedure for the appointment of Supervisory Board Members and CEOs to strategically important enterprises was originally approved in 2015. The selection of candidates for these positions was to be done in two stages. The candidates were preselected by the relevant line ministry and the final interviews were conducted by the Appointment Committee. This Committee was comprised of 5 line ministers and 5 independent experts.

In March 2018 the Nomination Committee was transferred from under MEDT to CMU (Resolution 190). Nomination Committee was comprised of 4 members (Minister of CMU, first deputy minister of MEDT, first deputy Minister of MoF, head or deputy head of ownership entity) and 4 independent experts, who did not have voting rights.

The final decision on the appointment of a CEO should be made by the supervisory board of the SOE or in the absence of the duly empowered supervisory board by the relevant ownership entity.

Source: State Property Fund.

Unfortunately in the case of Naftogaz the current independent and non-independent board of directors were not nominated and appointed according to these newly established practices. Rather, the newly appointed board members were selected according to an accelerated procedure, with vetting provided by a group of governmental appointees and international financial institutions acting as lenders to Naftogaz with input from key international donors. According to the government, the accelerated procedure was considered the best decision at the time to avoid running the company in the absence of an independent supervisory board.

## Notes

<sup>51</sup> Pursuant to Presidential Order, 151 (1998).

<sup>52</sup> It should be noted that some of the Company's subsidiaries are now being merged into it (either directly or indirectly), as their existence as separate business entities is not economically justified (Subsidiary Company "Naftogazobslugovuvannya" of the National Joint-Stock Company "Naftogaz of Ukraine", Subsidiary Company "Naftogazbezpeka" of the National Joint-Stock Company "Naftogaz of Ukraine", Subsidiary Company "Budivelnyk" of the National Joint-Stock Company

"Naftogaz of Ukraine"). LLC LIKVO is being merged into JSC Ukrgasvydobuvannya. All restructurings are purely intragroup reorganisation.

<sup>53</sup> The company reports that the positive impact of controllable factors on Naftogaz 2016 profit exceeded the impact of price increase and was much more important (impact estimated at UAH129bn) for the Company's overall performance.

<sup>54</sup> As noted in section 1, for many SOEs' audited financial statements come with a qualified opinion expressed by the independent auditor. This holds true for Naftogaz, however according to the disclosed statements a major part of the modifications in the auditors' report do not have significant impact on the financial statements 2017 and relate to comparability of the current year and the corresponding figures.

<sup>55</sup> The total taxes and duties also include social charges and other duties not included in table 2.6.

<sup>56</sup> Crude oil transit is subject to a VAT exemption. VAT is mainly a cash flow issue because of incoming and outgoing VAT; as such the company basically acts as a tax collector for the state.

<sup>57</sup> Notably until the price increase in 2015, the natural gas royalty rates for households (which were supplied by Naftogaz) stayed at 20% / 14% level (for production from gas seams less than / over 5000 meters deep respectively), increasing to 70% / 14% in Q2 2015 and staying at this level until Q2 2016 when Naftogaz selling price under PSO was increased. From Q2 2016, UGV royalty rate was fixed at 50% /14% until end of 2016, while private players enjoyed a more favourable 29% / 14% royalty regime. In 2017 the rates were 29% for production from seams less than 5,000 meters deep and 14 % from seams over 5,000 meters deep.

<sup>58</sup> The royalty rates depicted in the figure for 2017 and 2016 reflect the royalty rates applicable at the time of calculation. See footnote 40.

<sup>59</sup> Dividend rates were set at 50% for 2014 and 2016; and 75% for 2015 and 2017.

<sup>60</sup> Cabinet of Ministers of Ukraine #282-p dated 26 April 2017.

<sup>61</sup> The shareholder established special manner for payment of 2017 dividends: 30% percent were paid before 30 June 2018. The remaining 45% were divided into installments to be paid monthly by the end of 2018. Despite the fact that the CMU as the shareholder established these terms, the Company received a request for late payment charges for the delays. The demand was based on the provisions of the law pursuant to which dividends of SOEs should be paid before 1 July.

<sup>62</sup> Prior to the conflict with Russia, Naftogaz was highly reliant on state capital injections by the state and lending provided by state guaranteed financing from Russian state-owned financial institutions.

<sup>63</sup> <http://www.naftogaz.com/files/Information/EBRD-Action-Plan-engl.pdf>

<sup>64</sup> Resolution of the CMU No. 351 dated 26 April 2017 "On state ownership policy of Public Joint Stock company "National joint-stock company "Naftogaz of Ukraine"; Resolution of the CMU No. 526 dated 19 July 2017 "On approval of key performance indicators for the Supervisory Board of Public Joint Stock company "National joint-stock company "Naftogaz of Ukraine"; Resolution of the CMU No. 1052 dated 9 November 2016 "On approval of the manner of establishment of clear goals for the state unitary enterprises and business companies in which state holds more than 50 per cent of shares (participatory interest)"; and Resolution of the CMU No. 1067 dated 9 November 2017 "On approval of the procedure of disclosure of information on activities of the state unitary enterprises and business companies in which state holds more than 50 per cent of shares (participatory interest) and business companies more than 50 per cent of shares (participatory interest) in which belong to the state companies"

<sup>65</sup> The CMU Secretariat reports that a protocol decision was considered the best approach considering that the alternative approach to pass a law would have extended the adoption of such a decision by months.

<sup>66</sup> It is worth noting that the predominant form of SOE in Ukraine is the "state unitary enterprise", which can either be classified as a "Kazenni" or "commercial entity". The Kazenni are fully controlled by the government and are provided with operational management rights. Similarly, commercial entities are fully controlled by the government, but are granted business management rights and operate on a for-profit-basis. (IMF, 2016) An earlier OECD study (OECD, 2012) reviewing the corporate governance of Antonov identified a number of challenges with the unitary enterprise form of ownership. This legal form essentially allows SOEs to operate as extensions of government without the requisite legal personality and obligations that come with being incorporated, for example with regards to governance, transparency, auditing, and exposure to bankruptcy, etc. Recent reforms have tried to align the practices of unitary enterprises with JSCs, for example by requiring the commercially operating unitary enterprises to have audited financial statements; and gradually a select number of key unitary enterprises have been included in government plans to put in place supervisory boards with independent directors.

<sup>67</sup> <https://www.imf.org/external/pubs/ft/scr/2016/cr1631.pdf>.

<sup>68</sup> Pursuant to paragraph 3 of clause 3 of article 11 of the Law on management of state property objects, voting at general meetings on entering into major transactions for 25% and more of the SOE's assets, should be in line with voting instructions issued by the Ownership entity.

<sup>69</sup> It should be noted ambiguity in the language of CMU Resolution 747 which states "the shares are left in state-ownership and transferred to the authorized capital of Naftogaz," has created legal ambiguity regarding the shares and assets which contribute to the share capital of the Naftogaz as the parent company. The assets transferred to the share capital of the Company in 1998 were further used for establishment of the Company's subsidiaries, which until 2012 existed in the form of subsidiary enterprises and have been reorganised into joint-stock companies in 2012. The Company itself has established these subsidiaries, formed their share capital, and paid for their shares. However, due to ambiguous wording of Resolution 747, as well as the government resolutions approving establishment of the mentioned subsidiary joint stock companies, the government does not fully acknowledge the Company's full and clean legal title to the shares of its subsidiary joint stock companies.

<sup>70</sup> Supervisory board determines terms of employment contract and amount of remuneration for the CEO and Executive board members. Recommendations on remuneration of CEO and Executive board members of Naftogaz are provided by the Remuneration committee of the Supervisory board to the Supervisory board itself.

<sup>71</sup> It should be noted that the amendments to the Charter do not themselves remove the inefficient state controls and require further amendments to legislation.

<sup>72</sup> It should be noted that the Naftogaz parent company does not fully control the strategic direction and activities of its subsidiaries. For this reason, and going forward, the parent company has been reorganising the group to ensure that its subsidiaries operate in a more "semi-centralised" fashion, under "segment" groups rather than operating as autonomous fully incorporated entities. A longer term strategy might be to integrate fully incorporated subsidiaries back into the group.

<sup>73</sup> Article 51 (1) of the JSC Law.

<sup>74</sup> CMU resolution 142 from 10 March 2017 "Certain matters of governance in state unitary enterprises and business companies more than 50% shares in share capital of which are owned by the state": requires that supervisory boards with independent directors be put in place all SOEs that are either fully or majority owned by the state and which are economically important. This is defined as: (1) enterprises with a value of assets exceeding UAH 2 billion, net income exceeding UAH 1.5 billion or statutory capital for newly created SOEs of over UAH 2 billion; (2) if there are more than ten shareholders owning ordinary shares of an SOE. If an SOE does not meet the criteria indicated above during two consecutive years, it may take a decision to liquidate its Supervisory Board. These requirements have also been extended for unitary enterprises of a certain economic importance.

<sup>75</sup> The circumstances for their resignations will be discussed separately.

<sup>76</sup> CMU Resolution 142 from 10 March 2017 “Certain matters of governance in state unitary enterprises and business companies more than 50% shares in share capital of which are owned by the state”.

<sup>77</sup> It is worth mentioning that the gender equality envisaged by the Rules of Procedure of the Supervisory board of the Company in its first edition, has been removed by the government in March 2017.

<sup>78</sup> CMU Resolution as of 29 March 2017 No. 232 “Matters related to establishment of supervisory board in Public Joint Stock Company “National Joint-Stock Company “Naftogaz of Ukraine”.

<sup>79</sup> Given these requirements the Law on Management of State Property Objects envisages the possibility to obtain directors and officers insurance for the CEOs and members of Supervisory Boards of SOEs and such insurance cover is maintained regarding the current Supervisory Board members.

<sup>80</sup> It is worth noting that OECD, 2018 notes that due to the unclear interpretation as of who is covered by the Law on Prevention of Corruption, there is no consistent practice. Some SOEs have reportedly required almost all their employees to submit asset declarations while others have commissioned legal opinions that they are legal entities of the private law and this requirement does not apply to them and as a result no declarations have been submitted by the managers or employees of these SOEs.

<sup>81</sup> [https://www.coe.int/en/web/corruption/completed-projects/enpi/newsroom-enpi/-/asset\\_publisher/F0LygN4lv4rX/content/g7-urges-ukraine-to-cancel-e-declarations-for-anti-graft-activists?inheritRedirect=false](https://www.coe.int/en/web/corruption/completed-projects/enpi/newsroom-enpi/-/asset_publisher/F0LygN4lv4rX/content/g7-urges-ukraine-to-cancel-e-declarations-for-anti-graft-activists?inheritRedirect=false)

<sup>82</sup> These relate to burdensome tax reporting and enhanced public disclosure of detailed financial information which violates internationally agreed rights to privacy, non-discrimination and were criticized because of the lack of legitimacy and proportionality.

<sup>83</sup> It is envisaged that the system of internal control should have an internal risk management and control functions and matters accountable and subordinated to the executive body (except for certain most important authorities, such as the audit, that should be within the authority of the Supervisory Board).

<sup>84</sup> The government set the threshold for "largest companies" as follows: value of which, according to the financial statements for the last reporting year, exceeds UAH 2 billion or the net income of which exceeds UAH 1.5 billion for the last reporting year, as well as the State Railway Administration from the reporting year 2013 (Group 1); and, the value of which assets according to the financial statements for the last reporting year exceeds UAH 250 million (Group 2).

<sup>85</sup> According to the 2017 MEDT annual aggregate report (MEDT, 2017) the level of implementation of that requirement is still very low, with a little over 35% (or around 53 SOEs) qualifying entities in compliance with the resolution.

<sup>86</sup> It should be noted that the President no longer exercises direct appointment powers, as the appointment is now subject to a competition commission, but a recent Energy Community recommended further safeguards for members of the competition commission. (EC, 2018)

<sup>87</sup> Resolution of CMU as of 19 July 2017 No.526 “On approval of key performance indicators for supervisory board of the public joint stock company “National Joint-Stock Company “Naftogaz of Ukraine”.

<sup>88</sup> The stand-alone financial plan of Naftogaz was approved by the order of CMU #488-p from 19 July 2017 <https://www.kmu.gov.ua/ua/npas/250154322>

<sup>89</sup> Formerly known as the KRU.

<sup>90</sup> Under Ukrainian legislation, the amount of dividends is limited to net profit of the reporting period or other distributable reserves not exceeding retained earnings as calculated in the financial statements prepared in accordance with International Financial Reporting Standards.

<sup>91</sup> According to Naftogaz, Draft Law 6428, should have removed all ambiguous wordings and directly imply that all subsidiaries of the Company and other state companies should pay dividends to its shareholder (parent company), which in turn shall pay dividends to the State budget from net profit, calculated on the basis of consolidated statements.

## Chapter 3. Conclusions and Recommendations

Based on the analysis in sections one and two of this report, this third and final section identifies some key challenges with regard to the corporate governance reform of SOEs in the hydrocarbon sector and specifically the case of Naftogaz. It puts forward recommendations, which relate to the state in its various and sometimes conflicted roles as shareholder, policymaker, and regulator. Recommendations are also addressed to the corporate governance of Naftogaz. These recommendations are developed based on an iterative process, drawing on over 30 interviews carried out with various stakeholders over the course of the project, as well as discussions held with government authorities and company management on the first draft review, and subsequent comments received.

The recommendations draw on the OECD *Guidelines on Corporate Governance of State-Owned Enterprises* as their main reference document. However, this review does not systematically assess Ukraine's level of implementation of the Guidelines. This is done purposefully in view of the sectorial nature of the review; the focus on a company as case study; and a request by Ukrainian stakeholders to address the most pertinent areas for reform. Reflecting this, the review does not substitute for a comprehensive and systematic evaluation of Ukraine implementation of the SOE Guidelines, which the OECD would consider as a logical next step. As such, the recommendations herein do not prejudice any future review undertaken under the auspices of the OECD Working Party on State Ownership and Privatisation Practices should the Government of Ukraine wish to formally associate itself with the OECD legal instrument.

In parallel with this review, a number of targeted recommendations need to be designed to tackle the problem of state capture in SOEs. In this area, the OECD is actively monitoring the implementation by Ukraine of the Istanbul Anti-Corruption Action Plan, for which a monitoring with a focus on SOEs was concluded in 2018 (see attached Annex with a summary of recommendations emerging from that process).

The remainder of this section is organised as follows: a summary of the main conclusions of this review; a first set of recommendations primarily addressed to the state's role as owner and shareholder of Naftogaz; and, second set of recommendation focusing on the governance of the Naftogaz group. Key recommendations are summarised in the Table below and offered as a "Roadmap for SOE governance reform in the hydrocarbons sector."

### Conclusions

Given the importance of Naftogaz in the Ukrainian economy, its improved governance and performance can have far-reaching effects in all segments of the society, impacting the day-to-day lives of citizens, and other parts of the business sector. Consequently, its good governance is critical to ensure its positive contribution to economic efficiency, competitiveness and energy security.

The government has relied on Naftogaz to achieve numerous, and sometimes, conflicting objectives, and such actions towards Naftogaz due to the company's size and weight could

influence state finances considerably. Naftogaz has been an important public service provider ensuring the delivery of gas to heat homes and businesses, but it has faced considerable challenges recuperating losses both from unpaid debts by dubious intermediaries, and inadequate compensation mechanisms for rendering such services. As the main gas producer in Ukraine, Naftogaz will be an important player to meet ambitious objectives set by the Government for increased domestic gas production. At the same time, uncertainties regarding the future of gas transit routes through Ukraine (because of its conflict with Russia) and the threat posed by Russian-backed gas transit projects intended to reduce its reliance on Ukrainian transit routes, are risks that must be mitigated to ensure maximisation of value of Ukraine's hydrocarbons assets and energy security for Ukraine and the EU.

Recognising that the stakes are high, in 2014, the government embarked on an ambitious reform programme to support the transformation of the gas sector of Ukraine. This started with enacting the Natural Gas Market Law, which aimed to facilitate the implementation of the Third energy Package and other EU *acquis*, introduce transparent public service obligation (PSO) regime for categories of protected consumers; with plans to progressively align gas prices with the market. It has also specified a gas transit operator as part of its unbundling and certification requirements (to meet commitments made to the EU), while also introducing opportunities for more investment and private participation in the energy sector.

The transformation of Naftogaz was a key element of this broader reform process. With the support of EBRD, the CGAP was one of the tools implemented to assist Naftogaz in adopting these new commitments. Under the CGAP, the company went through an intense period of transformation. In the case of Naftogaz, some of the achievements during this period of reform included centralising the ownership of Naftogaz and putting in place the first-ever independent supervisory board in 2016. This transformation has not been without its challenges: the resignation of a number of supervisory board members has demonstrated the delicate nature of reform. However, these changes have been no small achievement in transforming the governance mechanisms in the company. The company (and sector) has since turned a profit after preceding years of being loss making; and has been leading a transformation of the group based on an integrated strategy in view of energy market reforms and with the aim of making a future public offering possible.

The transformation of Naftogaz is a potential good practice example and could be an important driver in the reform of the overall SOE sector in Ukraine. On the ownership side, the government also made some laudable advancements, including approving in October 2018 a basic ownership policy for the entire SOE sector, enacting a long-awaited Privatisation Law, while strengthening and professionalising board nominations practices and progressively putting into place independent supervisory boards in economically important SOEs; and since 2014 publishing an annual aggregate ownership report for the top-100 SOEs.

Despite the important reforms implemented to date, some observers comment that the pace of reforms has slowed and that reform appetite has waned. Unfortunately, progress in the corporate governance reform of Naftogaz has at times been offset by adverse developments. One of the most recent examples is restoration of restrictions on expenditures of Naftogaz until approval of its financial plan<sup>92</sup> (which is usually approved in the last days of the reporting year). Going forward, reforms should be irreversible and result in concrete and visible changes.



In order to move forward, the Government of Ukraine needs to see through the reforms that it started in 2014. In line with OECD Guidelines on Corporate Governance of SOEs, this will require particular efforts to strengthen the state-owner's ability to professionally and effectively exercise ownership rights; while continuing to improve corporate governance practices within the company. These reforms can go a long way in potentially shielding the group from future political interference and potential excessive intervention.

Additionally, without addressing risks of corruption and breach of integrity in certain areas of the hydrocarbons sector (including notably in gas distribution and supply as well as in licensing) and in the broader reform environment, the full benefits of improved corporate governance practices cannot be realised. In parallel, the state must work towards strengthening independent regulatory authorities and competition enforcement, while reinforcing anti-corruption prevention, investigation and enforcement bodies to carry out their work.

SOE reform in the hydrocarbons sector: Roadmap for reform	Responsible for Implementation			
	Whole of government	Ownership entity	Naftogaz	Other
Recommendations				
RECOMMENDATIONS ADDRESSED TO THE STATE AS OWNER AND SHAREHOLDER				
1.1 Upgrade the legal and regulatory framework and address any inconsistencies. Specifically: <ul style="list-style-type: none"> <li>Clarify inconsistencies between the Joint-Stock Company Law and Law on Management Objects of State Property;</li> <li>Approve draft Law 6428 to empower supervisory boards.</li> <li>Provide clarity on the ownership or management of assets for subsidiaries held by SOE parent companies;</li> <li>Revise the Joint-Stock Company Law and Law on Management Objects of State Property and clearly define fiduciary duties of <b>supervisory board's members</b>, due distribution of powers between supervisory and executive bodies, ownership of assets; and issues related to governance bodies in the two-tier system identified by the Joint-Stock Company Law.</li> <li>Develop a modern corporate governance code (equally applicable to private companies and SOEs) to clarify roles and responsibilities of corporate governing bodies and business processes, including for group companies.</li> <li>Improve the system of Property Register with regard to property rights and titles to land owned by SOEs.</li> </ul>	X	X		X
1.2 Establish a professional and centralised state-ownership entity that can champion SOE reform. Specifically: <ul style="list-style-type: none"> <li>Further separate policy role from exercise of shareholder rights;</li> <li>Separate regulatory role from all other roles;</li> <li>Pool experts on key matters such as financial reporting and board nomination.</li> </ul>	X			
1.3 Strengthen the independence, professionalism and capacities of the ownership entity responsible for Naftogaz.	X	X		
1.4 Remove conflicts of interest in the roles of the ownership entities of SOEs operating in the hydrocarbons sector.	X	X		
1.5 Clarify responsibilities of the ownership entity to ensure active and informed ownership, <b>while empowering it to speak with “one voice” to the company.</b>	X	X		

1.6 Improve two-way accountability and institutionalising dialogue between the shareholder and Naftogaz. This could be codified in the form of a <b>“framework agreement”</b> and cover all or some of the following areas: <ul style="list-style-type: none"> <li>Clarify frequency and format for dialogue, with a preference for the ownership entity to dialogue via the Chair of the board and encourage regular dialogue outside formal shareholder meetings;</li> <li>State ownership entity will dialogue with Naftogaz as the parent company on key strategic matters relating to Naftogaz Group;</li> <li>Commit parties to a reasonable timeline for the submission of key documents by the SOE; and,</li> <li>Commit parties to a reasonable timeline for the ownership entity to approve of key documents by the SOE, where shareholder approval is necessary (e.g. company charter, exceptional transactions); while concurrently empowering supervisory board for approvals of other key documents (i.e. corporate strategy, annual financial plans, etc.).</li> </ul>	X	X	
1.7 As a first step finalise discussion on and approve corporate strategy of Naftogaz <b>ensuring a balance between the state’s goals</b> and corporate performance and financial position objectives of Naftogaz. Subsequently, work with the company to set performance objectives, and empower supervisory board to approve the corporate strategy that fulfils shareholder objectives.	X	X	
1.8 The state should define the rationales for owning Naftogaz, and define public policy objectives that Naftogaz Group is required to achieve. These requirements should be clearly mandated by relevant authorities and disclosed. Specifically: <ul style="list-style-type: none"> <li>eliminate transitory measures related to regulated gas prices for all segments of natural gas market;</li> <li>where subsidies are proven necessary for vulnerable populations, ensure these are targeted appropriately and identify a way of offering direct rather than indirect subsidies to ensure additional transparency and integrity;</li> <li>ensure that compensation of public service obligations is competitively neutral (i.e. do not illegal state aid); transparent and subject to separate accounting;</li> <li>address corruption problems in the hydrocarbons downstream segments (in particular, supply and distribution); and,</li> <li>adoption of Network Codes based on EU rules which will have a key role for the development of the Ukrainian gas market.</li> </ul>	X	X	X
1.9 Identify and implement a transparent and competitively neutral compensation mechanism for public service obligations	X	X	
<b>RECOMMENDATIONS ADDRESSED TO NAFTOGAZ GOVERNANCE</b>			
2.1 Assign the necessary authority to the supervisory board to carry out core functions of hiring/firing of CEO, approve strategy, financial and investment plans, guidance and monitoring of management	X	X	
2.2 Assign an appropriate level of operational autonomy to the executive board and the CEO	X	X	
2.3 Eliminate the requirement for the government to approve business transactions, except in the case of exceptional transactions, in the presence of a proper system of internal controls	X	X	
2.4 Execute the unbundling of the gas transmission activities as envisaged by the Natural Gas Market Law and in view of international commitments	X	X	X
2.5 Consolidate the Naftogaz group to ensure it is competitive and value-enhancing	X	X	X

2.6 Improve the quality of financial and non-financial disclosure		X
2.7 Normalise the financing of Naftogaz and ensure it has access to finance from market sources	X	X

## 1. Recommendations addressed to the state as owner and shareholder of Naftogaz

### 1.1 Upgrade the legal and regulatory framework and address any inconsistencies

There is a number of uncertainties regarding the legal and regulatory framework for SOEs. Apart from the broader challenges highlighted under section 1.1 on the legal and judicial system, there is lack of coherence between the laws applicable to state-owned enterprises. In the case of Naftogaz, but generally for all SOEs and especially those incorporated as joint-stock companies, the legal framework is complex, multi-layered, ambiguous and contradictory. To recall, the main legal frameworks applicable to Naftogaz are the Law on Management Objects of State Property and the Joint-Stock Company Law. However, due to vaguely worded language the two laws are at times in contradiction of each other. Beyond these two laws, there is a complex web of regulations, procedures and rules applicable to SOEs which has contributed to an absence of clarity in the applicable rules for Naftogaz, and creates opportunities for potential future *ad hoc* intervention and corruption. Moreover, for the company it creates problems of ensuring compliance.

SOE Guideline II.A states, “*Government should simplify and standardise the legal forms under which SOEs operate. Their operational practices should follow commonly accepted corporate norms.*”

The Guidelines express a preference for laws applicable to SOEs to be based on corporate law, and to ensure that it is equally applicable to privately owned companies. In the case of Ukraine, where the law regulating governance of SOE may put forward specific requirements that go “above and beyond” requirements for privately owned companies, it should be clearly stated that the SOE law takes precedent on such occasions. Moreover, any such additional requirements should be clearly justified. At the same time, careful consideration should be made to ensure such standards do not put SOEs at an undue advantage or disadvantage.

In order to clarify the various laws and rules applicable, it is recommended to address the following priority areas:

- clarify inconsistencies between the SOE and company laws, and see through the state property reform strategy that was developed in cooperation with the IMF and World Bank in 2015;
- more support by Government for rapid progress by Parliament to approve draft Law 6428 to ensure that supervisory boards have the authority and are able to fully implement all duties as recommended by OECD guidelines on SOE governance;
- provide clarity on the ownership or management of assets of subsidiaries held by SOE parent companies;
- revise Joint-Stock Company Law and Law on Management Objects of State Property to define fiduciary duties of supervisory board’s members, due distribution of powers between supervisory and executive bodies, ownership of assets; and issues related to governance bodies in the *two-tier board system* identified by the JSC law;
- develop a corporate governance code, equally applicable to Ukraine’s private companies and SOEs, defining roles and responsibilities of the governing bodies. In line with Guideline IV. B, “*National corporate governance codes should be adhered to by all listed and, where practice, unlisted SOEs.*” The Code should take

into account the specifics of the Ukrainian legal environment, in particular existence of two-tier board structure with clear approaches to establishing efficient system of corporate governance, distribution of authorities, responsibilities and roles of governing bodies.

- clarify property rights and titles to land owned by SOEs to avoid any disputes regarding individual SOE's ownership rights.

### ***1.2 Establish a professionalised and coordinated state-ownership entity that can champion SOE reform***

A recent report by the OECD (2018)<sup>93</sup> assessing public administration reforms has identified “important concerns in the steering and co-ordination of some reform initiatives. Overlapping competences of public bodies in co-ordinating policy planning and in monitoring the Government’s performance in public service reform are clearly problematic. In some areas, responsibility is dispersed, unclear or incorrectly attributed.” This assessment is particularly evident in the area of state-ownership.

As identified in section 1.2 of the report, the size of the SOE portfolio is considerably large and until now, state-ownership has been fully decentralised. Often government entities carry out multiple and sometimes conflicting roles as owner, policy-maker and regulator/licenser. This creates conflicting goals and impedes the ability to manage SOEs effectively and professionally. Moreover, the inconsistent manner in which state-ownership has been exercised means that there is an incoherent policy towards the sector overall.

SOE Guideline II.D indicates: The exercise of ownership rights should be clearly identified within the state administration. The exercise of ownership rights should be centralised in a single ownership entity, or if this is not possible, carried out by a co-ordinated body. The “centralised entity” should have the capacity and competencies to effectively carry out its duties.”

Certain *ad hoc* initiatives to centralise and coordinate state-ownership have taken place to date. For example, the MEDT, under the Reform Support Team, produces the annual aggregate report for the top-100 SOEs; has drafted a basic ownership policy called the “Basic Principles of Implementation of Property Policy for State Enterprises”; and monitors the performance of a sub-set portfolio of SOEs. The centralisation of the nomination committee for board nominations and the list of companies slated for privatisation by the CMU are another example. The latter two examples, which make use of specific expertise in the Reform Delivery Office, Reform Support Team in the MEDT, and SAGSUR units, demonstrate how a coordinated and centralised approach to state-ownership can ensure both consistent orientation and implementation of policies, but also secure a degree of independence of the process from individual sector ministries.

Recognising the difficulty of establishing a fully centralised ownership function in a jurisdiction that has a very large and unwieldy portfolio of state-owned enterprises, a minimum requirement should be to establish a strong, independent and professionally staffed department to fulfil the ownership entity function placed at the centre of government.<sup>94</sup> This entity should (1) exercise full ownership rights in a small sub-set of economically important SOEs, including Naftogaz; while (2) coordinating the rest of the SOE portfolio. This unit would need to have the empowerment, capacity and competency to exercise ownership rights; while also coordinating among the different parts of government involved in state-ownership.

In its ownership role, the ownership entity would:

- exercise basic shareholder rights, including participating and voting in shareholder meetings; obtaining relevant information; electing and removing members of the supervisory board; approving extraordinary transactions; and voting on dividend distribution and enterprise dissolution.
- Bring together relevant competencies by organising “pools” of experts on key matters such as financial reporting or supervisory board nomination.

In its coordinating role, it should:

- act in an advisory capacity to other shareholding ministries;
- have a clear overview of the entire portfolio and ensure SOEs have a clear mandate and receive a coherent message in terms of strategic guidance or reporting requirements;
- monitor SOE performance;
- produce quarterly and annual reports of the whole SOE portfolio;
- coordinate supervisory board nomination processes; and,
- establish the overall state-ownership policy (establishing both the rationales for ownership but also rationales for divestment) in coordination with line ministries, and subject it to recurrent review.<sup>95</sup>

Careful consideration of the placement and future governance of such an entity should be made, to ensure it is adequately shielded from potential future political interference, excessive intervention and influence. Such a unit is well placed under the Prime Minister’s office; however, responsibility should be assigned to a responsible unit within the Cabinet of Ministers of Ukraine, which does not have concurrent responsibility for other functions, such as policy planning, regulating tariffs, setting public policy objectives, etc.

Ultimately, any centralised or coordinated entity should be made accountable to relevant representative bodies. Accountability should not restrict the autonomy of the entity to fulfil its responsibilities. At minimum annual reporting by the ownership entity to Parliament through an annual aggregate report (or similar reporting requirement) on the performance of the overall portfolio should be required. This can promote a culture of transparency and accountability on management of public funds according to generally accepted principles, such as value for money. More guidance is provided under *Guideline II.E* and relevant annotations. To this end, any future ownership entity should enjoy a degree of budgetary autonomy and be funded at the level similar to the Reform Delivery Office, to allow it the flexibility to recruit, remunerate and retain necessary expertise.

### ***1.3 Strengthen the independence, professionalism and capacities of the ownership entity responsible for Naftogaz***

The authority that manages corporate rights of the state in Naftogaz are formally exercised by the Cabinet of Ministers of Ukraine. This may appear, on paper, to be a reflection of more centralised or coordinated ownership, especially considering the role the Cabinet of Ministers is to play as outlined by the 2006 Law on Management Objects of State Property (see also paragraphs 33 to 35 for a description of its general role), and in steering the governance oversight of SOEs. However, upon closer inspection the review has found that CMU’s role as owner is in conflict with other roles that it currently carries out.

As far as the assessment could discern from its interviews, the authority that manages corporate rights of Naftogaz sits under the responsibility in the part of the CMU that also is responsible for energy affairs.<sup>96</sup> This will ultimately lead to a goal conflict, as this part of the CMU is also responsible for approving the government's overall policy in the energy sector; setting the public policy objective for gas provision to vulnerable households; and setting the price for the regulated market.

Considering the importance of energy security and energy matters to the economy of Ukraine, there is no question that policy guidance should be provided from the apex of government in coordination with relevant sectorial ministries, particularly with the Ministry of Energy and Coal, which is responsible for developing the Energy Strategy. However, these roles should be clearly separated from ownership and regulation as recommended under Guideline III.A, which states: *“There should be clear separation between the state’s ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation.”*

In view of more clearly separating these roles, proper safeguards must be found to move the exercise of ownership rights into a unit; clearly separated at arm's length from policy functions of the CMU. As a separate matter, any regulatory responsibilities that the CMU currently exercises should be shifted to an *independent* regulatory authority.<sup>97</sup>

#### **1.4 Remove conflicts of interest in the ownership of SOEs in the hydrocarbons sector**

The aforementioned goal conflicts are not only found in the way the ownership of Naftogaz is placed within the public administration, but also in the placement of ownership of other SOEs operating in the hydrocarbons sector. This includes but is not limited to:

- MGU, the future gas transmission operator, is owned by the Ministry of Energy and Coal. It is unclear the extent to which the Ministry has put into place the appropriate safeguards to ensure its role as energy policy maker are adequately separated from exercising ownership rights in MGU. The supervisory board has been selected via the nomination committee and is made up of a majority of independent directors. However, the interim management of the company has been nominated by the government (not the board). This is perhaps an interim measure, considering the financial situation of the company, in place until unbundling of gas transmission activities from Naftogaz is formally carried out. Between now and then, it is recommended to conduct a competitive recruitment process, similar to that is carried out for the independent directors in SOEs, to ensure the CEO and other senior management positions in MGU are selected according to an open, competitive process and based on experience and merit for whom the supervisory board is responsible. Nadra Ukrainy, which carries out gas and oil exploration, is owned by the sole natural gas resource licensing body in Ukraine, which is called the State Geological and Subsurface Service of Ukraine. The SGSS is guided and coordinated by the CMU via the Minister of Ecology. The role of this central government body to issue special permits (licences) and operate commercial operations in oil and gas exploration via SOEs are in clear conflict.<sup>98</sup> The state should separate licensing and commercial activity of the State Geological and Subsurface Service (SGSS) to avoid conflict of interest. Moreover, the SGSS should develop a transparent and competitively neutral procedure for issuing licenses. This should be done according to best practices in conducting open, competitive and transparent auctions for new licenses. Ultimately, such the award of license should stimulate hydrocarbon exploration and production efforts in Ukraine.



In both of these cases, appropriate safeguards should be in place to avoid goals confusion and conflicts of interest between branches of the state.

### ***1.5 Clarifying responsibilities of the ownership entity to ensure active and informed ownership, while empowering it to speak with “one voice”***

In the area of exercising shareholder rights, Guideline II.F states, “The state should act as an informed and active owner and should exercise its ownership rights according to the legal structure of each enterprise.”

With the Corporate Governance Action Plan of Naftogaz, a number of significant and laudable changes were made to the governance of the company itself. With Naftogaz being the first state-owned company to put in place an independent supervisory board, a change of culture is also necessary from the state. This means entrusting competent governing bodies of the company to fulfil their roles, while also balancing the owner’s need to influence and exert its rights as an active and informed shareholder. Clearly defining the state’s role as a shareholder is important to avoid day-to-day interventions into the company’s operations, while also establishing boundaries for acceptable conduct as the state owner to avoid being perceived as “political meddling.” The SOE Guidelines identify key areas where the state responsibilities should lie. These are covered in detail below with a brief assessment of the status of implementation in the case of Naftogaz:

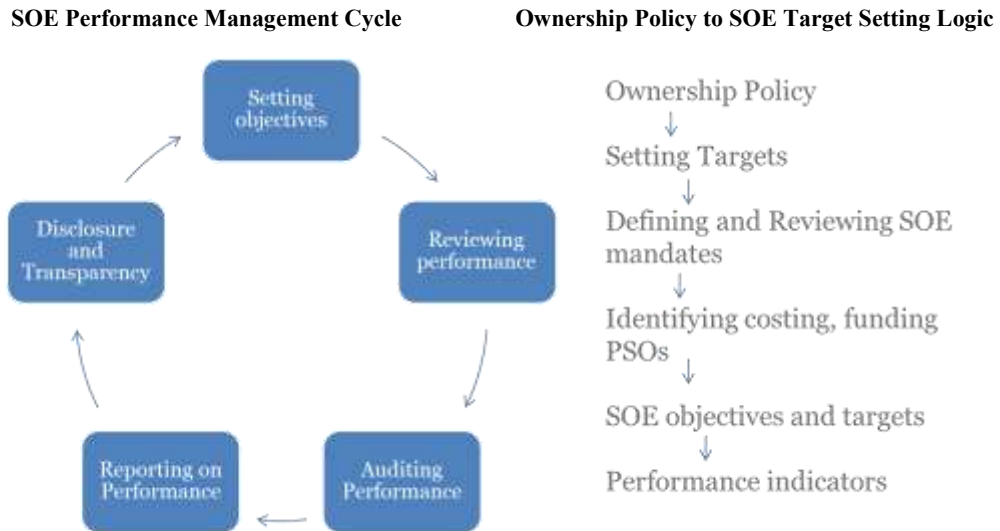
- *Being represented at the general shareholders meetings and effectively exercising voting rights:* Although the parent company is 100% state-owned the general meeting should be the main channel through which the state expresses its vote on key issues such as approving the annual report, appointment of auditor and supervisory board, changes in the articles of association/Charter and similar high-level issues. The formal approval for key documents such as the corporate strategy, financial, investment and business plans should lie with the supervisory board, with the owner informed. The general meeting should be viewed as an opportunity to engage as an informed owner, rather than a mere formality. On the other hand, the annual meeting does not substitute for regular, but structured, dialogue between the company’s supervisory board or executive board and the shareholder.
- *Establishing well-structured, merit-based and transparent supervisory board nomination processes in fully- or majority-owned SOEs, actively participating in the nomination of all SOEs’ supervisory boards and contributing to supervisory board diversity.* The establishment of a centralised and inter-ministerial supervisory board nomination committee, the involvement of the executive search firm, and the public announcement of supervisory board positions by the CMU is an important step forward to ensuring the supervisory board nominations occur based on a transparent, competitive and merit-based process. Although the nomination process can only be tested with time, potential improvements could be made including rotation of members of the inter-ministerial nomination committee. Future supervisory board nominations should avoid resorting to an accelerated procedure. Moreover, the current e-declaration system should not be deterring candidates to the supervisory board, therefore it might be considered to repeal such a requirement for international supervisory board members as recommended by the international community.<sup>99</sup>
- *Setting and monitoring the implementation of broad mandates and objectives for SOEs, including financial targets, capital structure objectives and risk tolerance levels.* This is an area where there is considerable room for improvement. Lengthy

and bureaucratic government approvals processes have left the company operating for over a year in the absence of an approved corporate strategy. As mentioned, annual financial plans are often not approved until the end of the same financial year which exposes Naftogaz to risks of non-compliance with the law. In the future, ownership expectations for Naftogaz should include detail on financial targets, capital structure objectives and risk tolerance levels.

- *A dedicated unit and professionally staffed ownership entity could ensure the government making informed decisions relating to Naftogaz's capital structure targets, dividend targets, financial targets, and more, speaking with "one voice" as its shareholder.* It could also challenge the supervisory board and management where there are divergences from ownership expectations. The OECD *Accountability and Transparency Guide* (2010)<sup>100</sup> provides useful guidance to the shareholder on how to structure this process. The OECD *Financing State-Owned Enterprises* (2014)<sup>101</sup> can also provide additional guidance on best practices in determining optimal capital structures and dividend targets.<sup>102</sup> As a rule, the dividend policy should ensure long-term value creation and future competitiveness of the SOE.<sup>103</sup>
- *Setting up reporting systems that allow the ownership entity to regularly monitor, audit and assess SOE performance, and oversee and monitor their compliance with applicable corporate governance standards.* On a yearly basis, the CMU sets key performance objectives for the supervisory board of Naftogaz. However, there is lack of formal engagement by the company to their development. An on-going and active dialogue is necessary between the company and its shareholder to come to an agreement on what is realistic, achievable and aligned with the shareholder's expectations. This process should be coupled with active monitoring and audit to assess performance, which according to the company does not occur in a systematic way. This is an essential role for the shareholder to evaluate the effectiveness of the Supervisory Board to meet the objectives set by the owner. Separate from the CMU's role, the MEDT is also responsible for carrying out overall performance monitoring of a broader portfolio of companies including Naftogaz. Any future monitoring should avoid being a formality, and should avoid any potential duplication with performance evaluation that the CMU would eventually carry out as the ownership entity. (See Figure 3.1 for an example of best practices in the cycle of objective setting and monitoring.)

**Figure 3.1. Ownership policy and corporate accountability: ensuring transparency and accountability**

To ensure this process is meaningful and realistic, the state owner will need to identify trade-offs between various objectives and indicate its priorities for Naftogaz. It should clarify how inherent trade-offs should be handled.



Source: Adapted from the OECD Accountability and Transparency Guide (2010).

- Developing a disclosure policy for SOEs that identifies what information should be publicly disclosed, the appropriate channels for disclosure, and mechanisms for ensuring quality of information. This is an area where considerable improvement has been made, at least in the case of Naftogaz. The state might consider using the example of Naftogaz to encourage other SOEs to follow suit, including reporting based on IFRS standards, the frequency of reporting is at least on annual and semi-annual basis; and ensuring that financial reports are subject to external independent audit and according to high-quality standards. Moreover having the audit function report directly to the supervisory board's audit committee is considered best practice.
- When appropriate and permitted by the legal system and the state's level of ownership, maintaining continuous dialogue with external auditors and specific state control bodies. According to best practice, the external auditor should report to the Audit and Risks Committee and be made accountable to the Supervisory Board of Naftogaz. This does not preclude that the owner is not involved in a dialogue with the external auditor. However, this dialogue should be necessitated when problems occur, and should not be at the expense of the board's responsibility. Knowledge on the part of the state owner of financial accountability is a prerequisite, further underlining the necessity to have a professionalised ownership function with the requisite capacities and skills. As for the state audit functions which are directly involved in the day-to-day operations of SOEs, CMU Resolution No.639 from August 22, 2018 is a welcomed development and swift measures should be taken to ensure these units are removed from SOEs; while also requiring economically important SOEs to establish robust systems of internal controls.

- Establishing a clear remuneration policy for SOE supervisory boards that fosters the long- and medium-term interest of the enterprise and can attract and motivate qualified professionals. The issue of board remuneration is a contentious one in Ukraine and the shareholder has faced pushback as part of negative public perception of board remuneration that appears to be excessive. Care should be taken to manage potential backlash, while also ensuring that the remuneration policy continues to remain attractive for top talent. A separate but related issue is with regard to the remuneration of executive management, for which incentive schemes should be designed in the long-term interest of the company. Both board and executive remuneration is transparent and disclosed in the annual report of Naftogaz. This is best practice that should be emulated by other SOEs.

### ***1.6 Improving two-way accountability and institutionalising dialogue between the state and Naftogaz parent company. This could be codified based on a “framework agreement”***

As it currently stands, the dialogue between the company and shareholder takes place at the highest level of decision-making, with the Prime Minister being the main contact for the Chair of the supervisory board. However, given the complexity of the company’s operations as well as the acceleration of reforms in the energy market, a structured and regular dialogue is needed at all levels including with the ownership entity notionally responsible for exercising shareholder rights.

Raising the capacities of the shareholder to interact with the company is necessary to allow for an informed dialogue. Moreover, clearly defining the responsibilities of the ownership entity, as outlined above, would set clear expectations from both the ownership entity and the company on their respective roles, while also facilitating a structured dialogue between the two. While the ownership entity should speak with “one voice” as a shareholder, involve other governmental departments in this dialogue should be encouraged when relevant.

To facilitate such dialogue a “Framework Agreement” should be drawn up which will institutionalise dialogue between the two parties (and where relevant involve other governmental departments). This agreement should, at minimum, aim to:

- Clarify frequency and format for dialogue, with a preference for the ownership entity to dialogue via the Chair of the supervisory board and encourage regular dialogue outside formal shareholder meetings;
- State that the ownership entity will dialogue with the parent company on key strategic matters related to Naftogaz Group;
- Commit parties to a reasonable timeline for the submission of key documents by the SOE; and,
- Commit parties to a reasonable timeline for the ownership entity to be informed of/approve key documents by the SOE, where shareholder approval is necessary (e.g. company charter, exceptional transactions, major changes to corporate strategy); while concurrently empowering supervisory board for approvals of other key documents (i.e. corporate strategy, annual financial plans, etc.).

***1.7 As a first step finalise discussion on and approve corporate strategy of Naftogaz ensuring a balance between the state’s goals and corporate performance and financial position objectives of Naftogaz. Subsequently, work with the company to set performance objectives, and empower the Supervisory Board to approve the corporate strategy that fulfils shareholder objectives.***

Defining the rationales for Naftogaz should not hinder the swift finalisation and approval of the group’s corporate strategy. Should a dialogue be necessary prior to its approval, this should take place between the ownership entity and the company’s board to reconcile any differences; especially if there are divergences with sectorial policies; public policy goals; or financial goals for the group. This dialogue should also consider plans for the future of the Naftogaz group (discussed further below) following the unbundling of the gas transmission activities, to ensure that the state-owner and company are fully aligned on the strategy approved by the Supervisory Board.

The ownership entity might also reconsider the formal requirement for it to approve the corporate strategy, which is not in line with generally accepted corporate practices. As discussed earlier, the shareholder should indicate, in advance, any public policy goals expected from the company, which can be clarified in the form of ownership expectations on broad mandates and objectives. The corporate strategy should be solely decided upon by the Supervisory Board and the shareholder should be informed. As pointed out in earlier sections, if dialogue between the company and shareholder occurs on a regular basis, there should be no “surprises” for the state owner on the content and direction of such a strategy. It might be helpful, in the context of a framework agreement, to determine the process and timelines expected from relevant parties for the setting of corporate objectives. Care should be taken to avoid that the state excessively intervenes in the process or that such dialogue is used as a means for potential future political interference.

Moreover, this would be a positive step in the direction of empowering supervisory boards to fulfil their mandate according to SOE Guideline VII.B, which states, “*SOE boards should effectively carry out their functions of setting strategy and supervising management, based on broad mandates and objectives set by the government.*”

***1.8 The state should define the rationales for owning Naftogaz, and define public policy objectives that Naftogaz and its subsidiaries are required to achieve. These requirements should be clearly mandated by relevant authorities and disclosed.***

The company-specific ownership expectations (also called “ownership policy” in Ukraine) for Naftogaz is a positive first step to give the owner’s vision for the company. Still it can be improved. Going forward, such a document should establish linkages with the existing Energy Strategy; obligations set out for the reform of the energy market under the Natural Gas Market Law and other commitments taken as part of integration into the European Energy Community. The ownership policy should clearly define the scope and range of public policy objectives to be carried out by the group. This will avoid situations which, in the past, have resulted in “add-on” obligations.

SOE Guideline I.D. states, “*The state should define the rationales for owning individual SOEs and subject these to recurrent review. Any public policy objectives that individual SOEs, or groups of SOEs, are required to achieve should be clearly mandated by the relevant authorities and disclosed.*”

In parallel, the CMU has provided a set of draft “owner’s expectations” to the board of Naftogaz. Both of these documents are important steps forward in communicating the state’s goals and strategy for the group. Going forward, the ownership entity of Naftogaz

should take steps to further elaborate ownership expectations for Naftogaz, which also includes setting financial and non-financial targets, and ensuring coherence with sectorial or other policy objectives. This could be done through an annual letter to the Chair of the Supervisory Board setting out high-level expectations/objective for the company and the expectation of the shareholder and relevant sectorial goals. This is an important tool to ensure that the supervisory board is directed to the high-level strategic goals of the shareholder. However, care should be taken that ownership expectations do not lead to “micromanagement” of the SOE or that they usurp the role of the board in strategy setting.

At the same time, the process of rationalising ownership of individual SOEs should not merely represent a formality. Such a process clarifying where there may be trade-offs between shareholder value, long-term investment capacity, public service obligations and other public policy goals. The shareholder must indicate its priorities for Naftogaz and clarify how inherent trade-offs should be handled. In doing so, it will avoid giving contradictory messages to the board and management as to the stated goals and expectations for the group. Moreover, it will avoid opportunities for “add on” public service obligations and potential future political meddling. Should Naftogaz be required to carry out “business transactions with other SOEs these should take place on market consistent terms according to the SOE Guideline IV.A.5.

### ***1.9 Identify a transparent and competitively neutral compensation mechanism for public service obligations***

The state should continue with the market liberalisation reform and switch from indirect (hidden) to target subsidies to focus on protection of the most vulnerable consumers. It is essential to ensure transparency of the public policy objectives in natural gas supply and implications for Naftogaz’ role in achieving these objectives. These policy objectives need to reflect in the overall PSO regime structure and choice of PSO regime designated participants. The public policy goals should be determined for Naftogaz and its subsidiaries, costed and accounted for separately according to good practices. Moreover, transparent means of compensation of public policy objectives must be defined.

SOE Guideline III.C states, “*Where SOEs combine economic activities and public policy objectives, high standards of transparency and disclosure regarding their cost and revenue structures must be maintained, allowing for an attribution to main activity areas.*” Moreover, SOE Guideline III.D states, “*Costs related to public policy objectives should be funded by the state and disclosed.*” In identifying and formulating future public policy obligations, the state-owner may wish to consider the following:

- eliminate transitory measures related to regulated gas prices for all segments of natural gas market;
- where subsidies are proven necessary for vulnerable populations, ensure these are targeted appropriately and identify a way of offering direct rather than indirect subsidies to ensure additional transparency and integrity;
- ensure that compensation of public service obligations are competitively neutral (i.e. do not constitute illegal state aid (in accordance with standards set by the European Energy Community), transparent, and subject to separate accounting;
- address risks of corruption and breach of integrity in the “last mile” to end consumer, in particular, the issue of non-payments by the regional gas supply companies and district heating companies (as well as the issue of unauthorized off-takes) should be addressed. For regional supply companies, this involves

establishing transparency and accountability and opening consumer data. For district heating companies, this involves reviewing the tariff structure to ensure their financial viability; and,

- adopt the Network Codes based on EU rules, which will have a key role for the development of the Ukrainian gas market.

## 2. Recommendations on governance of the Naftogaz Group

### ***2.1 Assign the necessary authority to the Supervisory Board to carry out core functions of hiring/firing of CEO, strategy, guidance and monitoring of management***

The Supervisory Board should be given the necessary powers to exercise their functions without undue interference in their activities. SOE Guideline VII.E. states, “*Mechanisms should be implemented to avoid conflicts of interest preventing board members from objectively carrying out their board duties and to limit political interference in board processes.*”

Once an independent supervisory board of an SOE has been appointed and formed necessary committees, it should be vested with the authorities that are at least not less than those granted by law to a private company. At the same time, it is important that the Supervisory Board is not overloaded by operational issues and that the CEO and executive body have a pre-agreed ambit of operational freedom to manage the group. The supervisory board cannot set the risk appetite for Naftogaz and make key strategic decisions if it is disempowered by the shareholder function stepping into this role simultaneously. SOE Guideline VII.B states, “SOE boards should effectively carry out their functions of setting strategy and supervising management, based on broad mandates and objectives set by the government. They should have the power to appoint and remove the CEO. They should set executive remuneration levels that are in the long term interest of the enterprise.”

At the same time, board members should be held accountable if they breach fiduciary duties. Guideline VII.A states, “The role of SOE boards should be clearly defined in legislation, preferably according to company law. The board should be fully accountable to the owners, act in the best interest of the enterprise and treat all shareholders equitably.” This can serve to balance the shareholder’s concerns about ceding some of its powers to a genuinely empowered board, which in turn should be held accountable to act in the best interest of the company

The roles of the Supervisory Board of Naftogaz must be clarified going forward with focus on following areas is recommended.

- The Government is recommended to provide more support to the implementation of legislative changes in draft law 6428.
- Supervisory Board should be empowered to appoint/dismiss CEO and decide on remuneration; this will also ensure that the CEO is insulated from outside pressure and or risks being captured by various interests;
- Supervisory Board’s role should be clearly delineated from that of executive management and the shareholder - it should be empowered to set strategy, enhance value and challenge the executive management;
- Empower boards to formally approve corporate strategy and financial plans, which at the current juncture will also require moving these responsibilities away from the shareholder’s current scope of involvement; at the same time supervisory board members should held accountable according to their fiduciary duties.

### ***2.2 Assign an appropriate level of operational autonomy to the executive board and the CEO***

Some recent legislative changes have progressively vested supervisory boards with management and operational authorities, which would normally be delegated to the executive board and the CEO. This has resulted in weak division of roles of governing



body, while also burdening the Supervisory Board with decision-making that would normally fall within the operational authority of the executive board or the CEO. Going forward the government should consider:

- Resolve ambiguities in the roles and responsibilities of governing bodies, in the case of Naftogaz this could be addressed through a revision of the company's Charter;<sup>104</sup> and,
- Further clarify roles and duties of the Supervisory and executive boards, as well as the responsibilities of the board with regard to subsidiary companies which a modern corporate governance code could serve to address and clarify,
- Ensure that the executive body of Naftogaz as a central manager of the group is fully empowered to fulfil shareholder role of its subsidiaries without intervention from the state.

### ***2.3 Eliminate the requirement for the government to approve business transactions, unless “extraordinary”, in the presence of a proper system of internal controls***

Under the Corporate Governance Action Plan of Naftogaz, the company was required to establish a system of external audit and internal control, which it developed with the assistance of international consultants. The system established key controlling functions including financial control, risk management, compliance and internal audit in Naftogaz and its subsidiary companies.

The establishment of such bodies is in line with the SOE Guidelines VII.J, which states, “SOEs should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board and to the audit committee or the equivalent corporate organ.” Moreover, Guideline V.C states, “The boards of SOEs should develop, implement, monitor and communicate internal controls, ethics and compliance programmes or measures, including those which contribute to preventing fraud and corruption. They should be based on country norms, in conformity with international commitments and apply to the SOE and its subsidiaries.”

The establishment of such a system was, *inter alia*, a pre-requisite to remove some of the inefficient state controls envisaged under CMU Resolution 899, which required CMU approval for key expenditures, including executive remuneration (bonuses), in the absence of an approved financial plan. As of September 2018 the state reinstated the applicability of CMU Resolution 899 to Naftogaz. This reinstatement hinders the supervisory board from effectively carry out duties according to the reforms envisaged by the Corporate Governance Action Plan.

Acknowledging the shareholders' rights to influence the corporation on certain fundamental issues, one of the basic shareholder rights is the approval of “extraordinary” transactions. However, “extraordinary” should be clearly defined. According to the OECD Principles of Corporate Governance, this can include: mergers, and sales of substantial portions of corporate asset; and substantial investment into equity or other types of issues as specified in company law and internal company statutes. Anything other than “extraordinary,” should be subject to approval by the appropriate governing body of the company.

#### ***2.4 Execute unbundling of the gas transmission activities as envisaged by the Natural Gas Market Law***

Under the obligations to be met by Ukraine's integration in the European Energy Community, it has committed to unbundling of gas transmission from supply and production. It has since legislated the options of "ownership unbundling" and "independent system operator" as part of the Natural Gas Market Law. Following the February 2018 ruling of the Stockholm arbitration, the government in consultation with MGU and Naftogaz has been working towards developing an "Action Plan of Energy Sector Transformation." This Plan provides more details on how to roll out the Law and Strategy, including how to see through unbundling of the gas transmission system operator, as legislated while respecting the outcome of the Stockholm Arbitration and taking into consideration possible scenarios of natural gas transit through Ukraine beyond 2019. In July 2018, the two companies have agreed on a memorandum of understanding regarding a roadmap towards the unbundling of the transmission service operator. The recently announced agreed action plan between Supervisory Boards of Naftogaz and MGU is a welcomed step forward in setting in motion the execution of the Natural Gas Market Law, and further efforts should be made to ensure that both parties respect the agreed action plan. The state should ensure that the independent supervisory boards of both companies are insulated from potential future political meddling and that appropriate safeguards are in place to ensure a smooth roll out of the unbundling process.

#### ***2.5 Consolidate the Naftogaz Group to ensure it is competitive and value-enhancing***

To ensure continued economic viability of Naftogaz after unbundling of its gas transmission business, the company's supervisory and executive boards and management will have to develop the strategy to transform Naftogaz along its entire value chain. For Naftogaz to remain competitive and generate value the following should be taken into account:

- Best corporate governance practices should be implemented throughout Naftogaz, taking into account its Group structure;
- Finance, human resource, strategy, legal, IT and other functions at the group level should be streamlined to reflect best practices in company group organisation and ensure relevant functions are not duplicated in individual subsidiaries;
- Naftogaz should have control over its assets, including those that are owned by fully-owned subsidiaries;
- The company needs to be adequately and sustainably compensated for fulfilling public service obligations;
- The influence and role of vested interests and corruption in parts of the hydrocarbon supply chain (especially in supply and distribution) must be addressed including debts owed to Naftogaz by these companies; in this vein, introducing competition in the sale of gas to end-customers should be envisaged;
- The strategy and objectives of the company should be consistent with the Energy Strategy, including in fulfilling energy security goals and other ambitions for the oil and gas sector in Ukraine; and,
- Any future regulatory changes that are envisaged as part of the Natural Gas Market Law or other in other areas affecting its business.

## **2.6 Improve quality of financial and non-financial disclosure**

As discussed in section 2.2.8 of the report, Naftogaz complies with CMU Resolution 1067, which requires majority owned SOEs to disclose quarterly and annual financial statements (the latter should be prepared in accordance with International Financial Reporting Standards), as well as audit opinions on annual statements. The company is further required to have its financial statements audited by internationally recognised audit firms. It should be noted that Naftogaz was among the few large companies in Ukraine, state-owned or private, that has been subject to enhanced transparency and disclosure practices prior to the CMU resolution.

Guideline VI states, “*State-owned enterprises should observe high standards of transparency and be subject to the same high quality accounting, disclosure, compliance and auditing standards as listed companies.*”

Going forward, Naftogaz should:

- aim to have financial statements that reflect full information and disclosure, to ensure that future financial disclosure is not subject to qualified opinions from auditors; and,
- as per best practice, the auditor should report to the supervisory board; although as discussed the state should have an informed dialogue with the external auditor should there be concerns.

## **2.7 Normalise the financing of Naftogaz and ensure it has access to finance based on market conditions**

As noted in section 2.1.5 of the report, Naftogaz faces considerable challenges to raise capital, as it is required to get government approval to obtain loans, as well as guarantees or sureties for its loan agreements. Apart from being administratively burdensome, it also does not reflect best practices as the company should be able to access finance based on market consistent terms. As a general principle, the state should not give an automatic guarantee in respect of SOE liabilities. Fair practices with regard to the disclosure and remuneration of state guarantees is necessary and where necessary corrective measures might be warranted to ensure competitive neutrality.

Another challenge relates to the fact that Naftogaz borrows primarily from state-owned financial institutions. Reliance on state-owned financial institutions may shelter SOEs from a crucial source of market monitoring and pressure, thereby distorting their incentive structure and leading to excessive indebtedness, wasted resources and market distortions. The relationship should be based on purely commercial grounds. State-owned banks should grant credit to SOEs on the same terms and conditions as for private companies. These mechanisms could also include limits on, and careful scrutiny of, SOEs’ board members sitting on the boards of state-owned banks

Going forward, Naftogaz should be encouraged to seek financing from capital markets. For this to occur, the company must be allowed to pledge its assets as collateral or sell assets or shares of subsidiary companies.

SOE Guideline III. F states, “*SOEs’ economic activities should face market consistent conditions regarding access to debt and equity finance. In particular: 1. SOEs’ relations with all financial institutions, as well as non-financial SOEs, should be based on purely commercial grounds.*”

Going forward, the company and state-owner should:

- Ensure that the conditions for Naftogaz to access finance are normalised and consistent with practices in the private sector;
- Naftogaz should be encouraged to seek financing from capital markets, including through the issuance of bonds, and should be allowed to pledge its assets as collateral or sell assets or shares of subsidiary companies with the proper approval of the Supervisory Board (not from its shareholder); and,
- Access finance from state-owned and other financial institutions should be based on commercial grounds to ensure a level playing field.

## Notes

<sup>92</sup> CMU Resolution dated 18 July 2018 No.718 amended CMU Resolution dated 3 October 2012 No.899 “On approval of expenditures by the subjects of the state sector of economy in case their annual financial plans are not approved (endorsed) in the due course” and thereby restored limitations on expenditures for Naftogaz.

<sup>93</sup> OECD 2018 Sigma Baseline Assessment.

<sup>94</sup> Centralisation of a subset of the portfolio could be a first step towards a fully centralised ownership in the future when the size of the portfolio is more manageable. This could happen by a gradual decrease in the number of shareholding institutions (ministries and agencies), and reduction of the overall portfolio of SOEs through a rigorous implementation of the Privatisation Law, to avoid excessive fragmentation. For example, the SPF could maintain ownership of SOEs slated for privatisation and even liquidation, while the remainder of the portfolio of strategic companies is gradually transferred to the CMU (or other new entity).

<sup>95</sup> It should be noted that a basic ownership policy has been developed by the MEDT, and approved by the CMU in October 2018, called the “Basic Principles of Implementation of Property Policy for State Enterprises.” The state enterprise ownership policy should provide SOEs, the market, and the general public with predictability and a clear understanding of the state’s overall objectives and priorities as an owner. The ownership policy should ideally take the form of a concise, high-level policy document that outlines the overall rationales for state enterprise ownership. The state should also include information on rationales for owning individual SOEs, and subject this to a recurrent review. On 26 April 2017, the CMU has adopted the Resolution # 351 “On Approving Key Foundations for Exercising State Ownership of National Joint-Stock Company “Naftogaz of Ukraine” (further – the Resolution) which contains high-level Naftogaz state ownership objectives and priorities, Naftogaz performance expectations and corporate governance principles that the State in the face of the CMU see Naftogaz adhering to.

<sup>96</sup> As far as the MEDT indicates there are two Departments in the CMU which are responsible for Naftogaz, these include the 1) Department for Effective State Property Management; and, 2) the Department for Development of the Fuel and Energy Complex and Housing and Communal Services; however, at the closed-door meeting with the government it was made clear that in practice the CMU Secretariat plays no role in the exercise of ownership of Naftogaz.

<sup>97</sup> As far as the assessment understands, the CMU has only been responsible for establishing the price for the regulated market as part of “transitory measures.” (More on public policy objectives will be discussed separately). A separate but related issue is ensuring that existing regulatory bodies act independently, and out of the influence of vested interests.

<sup>98</sup> An Independent Assessment of the State Geological and Subsurface Service of Ukraine came to similar conclusions regarding the conflicts of interest, but to date it appears that its recommendations to separate licensing activities from commercial activities have not been implemented.

<sup>99</sup>[https://www.coe.int/en/web/corruption/completed-projects/enpi/newsroom-enpi/-/asset\\_publisher/F0LygN4lv4rX/content/g7-urges-ukraine-to-cancel-e-declarations-for-anti-graft-activists?inheritRedirect=false](https://www.coe.int/en/web/corruption/completed-projects/enpi/newsroom-enpi/-/asset_publisher/F0LygN4lv4rX/content/g7-urges-ukraine-to-cancel-e-declarations-for-anti-graft-activists?inheritRedirect=false)

<sup>100</sup> <https://doi.org/10.1787/9789264056640-en>

<sup>101</sup> <https://doi.org/10.1787/9789264209091-en>

<sup>102</sup> According to best practice, a systematic process for determining the capital structure of SOEs, which takes into account the interdependence between capital efficiency, rate-of-return requirements and dividend pay-outs should be in place. SOE boards and management take the lead regarding capital structure decisions, but taking into account clear governmental guidance. Explicit guidelines for developing an optimal capital structure should be developed by the state owner but should include benchmarking with listed peers affecting capital structure.

<sup>103</sup> It is considered best practice to communicate broad expectations regarding dividend levels, linking annual pay-out ratios to the achievement of an optimal capital structure. In some cases, the authorities might find it useful to communicate a target credit rating by which to measure the optimal capital structure, and this acts as an overarching guiding principle for annual dividends.

<sup>104</sup> It should be noted that a revision of the Charter of Naftogaz has already been endorsed by the supervisory board. In this revision, clearer assignment of roles and responsibilities of the respective governing bodies has been made. Approving the Charter could be a step forward in addressing ambiguities introduced by recent legislation without having to revisit the legislation itself.



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## Annex A. Specific Responsibilities of Naftogaz Supervisory Board as outlined in the Company Charter

### Article 69

- 1) Approval, according to the Supervisory Board's authority, of all rules of procedure and regulations applicable to the Company's affairs, other than required to be approved by the General Meeting;
- 2) Preparation and prior approval of the agenda for and notice convening the General Meeting, approval of the date for the General Meeting, resolutions on whether to include any proposals into the agenda, other than convening the extraordinary General Meeting at the request of the shareholders, and approval of proposed resolution on the matters in the agenda;
- 3) Resolution on whether to hold an annual or an extraordinary General Meeting as provided for in the Charter, or in the events provided for in applicable laws;
- 4) Approval of offering or placement by the Company of the securities other than the shares for the amount below or equal to 25 per cent of the Company's total assets as reflected in its latest annual financial statements;
- 5) Approval of buy-out by the Company of its outstanding securities other than the shares;
- 6) Approval of the market value of the assets, if so required by applicable laws;
- 7) Approval of the terms and conditions of contracts to be entered into with the Chief Executive Officer and the Executive Board members, determination of their remuneration, and appointment of the person authorized to execute such agreements;
- 8) Appointment of the Company's auditor, determination of the terms and conditions of agreement to be entered into with such auditor, and determination of fee for its services;
- 9) Resolution on the matters pertaining to the Company's participation in any business companies, or associations, or to the establishment of any other legal entity;
- 10) Resolution on the matters reserved to the exclusive competence of the Supervisory Board by applicable laws, in the event of merger, acquisition, split-off, spin-off or transformation of the Company;
- 11) Making decision on any material transaction, if the market value of the property, or services covered by such transaction amounts to 10 to 25 per cent of the Company's total assets as reflected in its latest annual financial statements;
- 12) Making decision on approval of interested party transactions, in cases provided for in the law or internal regulations of the Company;
- 13) Determination of likelihood of the Company's insolvency as a result of incurring or discharging any liabilities, including as a result of dividend payment or shares buy-out;
- 14) Making decision on the appointment of the valuator for the Company's assets, approval of the terms and conditions of agreement to be entered into with such valuator, and determination of fee for its services;
- 15) Making decision on the appointment (replacement) of the depository providing additional services to the Company, approval of the terms and conditions of agreement to be entered into with such depository, and determination of fee for its services;
- 16) Establishment of the Supervisory Board committees, approval of the regulations on such committees and of the list of matters to be submitted for the research into, and elaboration of respective proposals, by any such committee;
- 17) Appointment and removal of the corporate secretary;

18) Ensuring risk management and internal control, chief risk officer appointment and removal, and approval of chief risk officer regulation and risk management program;

19) Appointment and removal of chief compliance officer, anti-corruption officer, chief audit executive, and approval of regulations thereon;

20) Approval of anti-corruption and compliance programs;

21) Pre-approval of draft annual accounts to be approved at the General Meeting;

22) Annual evaluation of its performance and preparation of annual report of the Supervisory Board;

23) Prior approval of the decisions of the Executive Board regarding the business companies in which the Company is the sole shareholder (founder, participant) in particular concerning:

- amendment of their Charters;
- their reorganization and liquidation;
- increase or decrease of their share capital;
- appointment and removal of the chief executive officer;
- appointment of executive body members in case of a disagreement as to nominees between the Executive Board of the Company and a chief executive officer of the relevant business company;
- suspension of the chief executive officer and appointment of a temporary acting chief executive officer;
- approval of the terms and conditions of contracts to be concluded with the chief executive officer, establishment of his/her remuneration;
- approval of the strategy, financial plan, business plan and investment plan;
- approval of rules of procedures of the General Meeting and of the Executive Board;
- prior approval of agreements, prescribed by articles 70, 71 of the Law of Ukraine “On Joint Stock Companies” as well as other transactions which shall be subject to the prior approval by the Supervisory Board of the Company under the provisions set out in this Charter;

24) Cancellation of a decision by the Executive Board on suspension or removal of a member of an executive body of a business company in which the Company is the sole shareholder (founder, participant);

25) Approval of the manner to perform internal audits of business activities of business companies in which the Company is the sole shareholder (founder, participant);

For the business companies in which the Company is the sole shareholder (founder, participant) the decisions of the Supervisory Board adopted on the matters indicated in clauses 24 and 25 of this article shall serve as a basis to adopt the resolution of the General Meeting of the shareholder (participant);

26) Submission of proposals regarding changes to this Charter;

27) Approval of the execution of:

- transactions on sale, purchase, supply, and other trading operations regarding natural gas, energy resources which are in excess of:
- UAH 10 billion or its equivalent in any other currency calculated at the official rate of the National Bank of Ukraine as of 31 December of the year preceding the transaction regarding purchase of natural gas by the Company;
- UAH 5 billion or its equivalent in any other currency calculated at the official rate of the National Bank of Ukraine as of 31 December of the year preceding the transaction regarding sale, supply of natural gas by the Company;

Other transactions which are in excess of UAH 3 billion or its equivalent in any other currency calculated at the official rate of the National Bank of Ukraine as of 31 December of the year preceding the transaction either as a single or combination of related transactions linked by the same project and/or party;

28) Resolution of any other matters reserved to the Supervisory Board as provided for in this Charter and applicable law.

***Article 70***

The Supervisory Board shall have the right to resolve on any other matters (other than those reserved exclusively to the General Meeting), as may be required for the efficient performance of duties assigned to the Supervisory Board as well as for management of current operations of the Company.

## Annex B. Specific responsibilities of Naftogaz Executive Board as outlined in the Company Charter

- 1) Implementation of plans and resolutions of the General Meeting and the Supervisory Board;
- 2) Administration of the Company's cash and assets, subject to any limits as determined in this Charter or other Company regulations (rules and orders etc.);
- 3) Prior consideration of any matters to be discussed at the General Meeting and at the Supervisory Board meeting, preparation of respective materials required for consideration of such matters, and procurement of implementation of decisions and resolutions of the General Meeting and the Supervisory Board;
- 4) Resolution on any matters pertaining to management of legal entities in which the Company is the shareholder (founder, participant), as well as branches, representative offices, other separate business units. For any subsidiary established by the Company, any Executive Board resolution shall be deemed a resolution of its highest governing body, i.e. the founder, and shall be binding upon its sole or collegial executive body. For any business company in which the Company is the sole shareholder (founder, participant), the Company's Executive Board resolution shall be the basis for executing the resolution of its General Meeting of shareholders (participants) bearing the signature of the Chief Executive Officer. For any business company in which the Company is not the sole shareholder (founder, participant), an Executive Board resolution shall be the basis for executing the instruction to the Company's representative to vote at the General Meeting of shareholders (founders, participants) of any such business company.

The approval of the following transactions shall fall within the competence of the Executive Board under this clause:

- transactions by legal entities in which the Company is the sole shareholder (founder, participant), which are in excess UAH 500 million or its equivalent in any other currency calculated at the official rate of the National Bank of Ukraine as of 31 December of the year preceding the transaction, if such transaction is within the limits set out in the approved financial plans of such legal entities;
- transactions by such legal entities which are in excess of UAH 200 million or its equivalent in any other currency calculated at the official rate of the National Bank of Ukraine as of 31 December of the year preceding the transaction, not included or beyond the limits set out in the approved financial plans of such legal entities;
- other material and interested-party transactions by such legal entities pursuant to the law and their statutory documents.

Approval of the aforementioned transactions which exceed the threshold set forth in clause 27 of article 69 of the Charter shall be made only if there is a prior approval of the decisions of the Executive Board of the Company by the Supervisory Board of the Company;

- 5) Approval of financial plan and business plan of any legal entity in which the Company is the sole shareholder (founder, participant);
- 6) Approval of investment plan of any legal entity in which the Company is the sole shareholder (founder, participant).
- 7) Approval of reorganization and liquidation of subsidiaries (business companies) established by the Company, appointment of the reorganization and termination commissions;
- 8) Amendments to charters of subsidiaries (business companies) established by the Company;
- 9) Resolution on any matters pertaining to organization of business, finance, accounting, reporting and securities transactions;
- 10) Resolution on establishment and liquidation of branches, representative offices and other separate business units, and approval of regulations thereon;
- 11) Appointment and removal of the financial controller, approval of regulations thereon;
- 12) Performance of other duties vested in the Executive Board as provided for in the resolution of the General Meeting or the Supervisory Board.

## Annex C. OECD Recommendations with a focus on prevention and prosecution of corruption in SOEs in Ukraine

### Istanbul Anti-Corruption Action Plan: OECD 4<sup>th</sup> Monitoring of Ukraine with a focus on Prevention and Prosecution of Corruption in SOEs

The Istanbul Anti-Corruption Action Plan (IAP) is a sub-regional peer-review programme, hosted by the OECD. It carries out country reviews and continuous monitoring of participating countries' implementation of recommendations to assist in the implementation of the UN Convention against Corruption and other international standards and best practice. Ukraine is a member of this Programme and selected the topic of "prevention and prosecution of Corruption in SOEs" among the topic to be covered in a fourth round of monitoring of its implementation of the IAP. These recommendations were adopted on 4 July 2018.

1. Take prompt measures to collect precise and timely data on all SOEs in central government ownership and ensure that financial and non-financial information is of high quality. Special priority should be given to information in regards to: (a) unitary enterprises governed by the sole director, due to their high exposure to corruption risks and (b) top 100 SOEs, which account for majority of revenue and assets.
2. Carefully evaluate and disclose the objectives that justify State ownership, adopt and make them public in a form of a State ownership policy, covering all SOEs, with special attention given to most economically important SOEs, and subject this policy to a review at regular intervals. Define the role, the authority and the organisation of the State in the governance of SOEs and explain how the State will implement this ownership policy. Ensure that individual SOEs objectives are developed and consistent with the policy and are disclosed.
3. Streamline the legislative framework regulating the governance and operations of SOEs, ensuring that SOEs operational practices should follow commonly accepted corporate norms. In particular, due to high risk of corruption incorporate unitary enterprises into JSCs or other commonly used corporate forms, fully eliminating corporate forms exclusively reserved to SOEs. These enterprises should be ensured the proper and undisputed legal ownership of all their assets.
4. Move towards a fully centralised form of SOE ownership and ensure that any institution vested with this role is made up of qualified professionals and is shielded from undue interference.
5. A. Ensure that supervisory boards, with a majority of independent members, are established in SOE and that this is done through a well-structured, merit-based and transparent nomination process. Ensure that supervisory boards have the necessary powers and can exercise their functions without undue interference in their activities.  
B. Abandon the rights of State authorities to select and appoint CEOs and other executives of SOEs authorizing the supervisory boards to do this through a transparent and skill-based selection process; ensure that the CEOs are insulated from outside pressure and interference in the day-to-day operations of their SOEs.
6. Conduct proper performance control of SOEs by ensuring that: a. SOEs report timely and in full scope required by legislation on their performance to the ownership entities; b. ownership entities perform proper economic and financial analysis and their decisions to steer the SOEs follow such evaluations; c. ownership entities provide full information in regards to the performance of their SOEs to the MEDT enabling it to conduct an in-depth analysis; and, d. results of performance evaluation are taken into account when policy, strategic or management decisions regarding the SOEs governance are taken.
7. Provide for effective financial control over SOEs by: a. ensuring that internal audit function is established and functioning in SOEs; b. ensuring that large SOEs are externally audited by highly qualified independent auditors in line with IFRS requirements; c. reviewing current functions of the State Audit Service in regards to SOEs and, at the minimum, eliminating its duplicating functions with the internal control of the SOEs, the financial performance control by ownership entities, and the verification of

- financial performance by MEDT; and, d. Ensure that audit functions are not used for political or other improper interference in the operations of SOEs.
8. A. Ensure full and transparent reporting by the SOEs with due regard to enterprise capacity and size. Financial and non-financial reporting should be in line with high quality internationally recognised standards of corporate disclosure and should include areas of significant concern for the state and the public, such as anti-corruption measures and instruments in place to prevent and manage conflict of interests. Care should be taken that additional reporting obligations placed on SOEs beyond those placed on private enterprises do not create an undue burden on their economic activities.  
B. Continue and improve the aggregate reporting by MEDT and consider translating that reporting into other languages.
  9. Ensure rigorous implementation of the new Law on Privatisation.
  10. Properly resource the pre-privatisation and privatisation functions of SPFU and enable it to carry out its tasks, inter alia ensuring the timely transfer of SOEs which have been earmarked for privatisation into the ownership of the Fund.
  11. Ensure full transparency and integrity of the privatisation process by rigorously implementing provisions on prevention of conflict of interest for all participants of the privatisation process, including members of the auction committees, external advisers and persons responsible for privatisation within the privatisation bodies.
  12. Take measures to efficiently reduce the number of SOEs, including liquidations, mergers and other restructuring.
  13. A. Ensure that addressing corruption in SOEs finds its proper reflection in the new policy documents and that measures designed in previous documents have been implemented or transferred into the newly adopted policy documents.  
B. Introduce anti-corruption programmes in SOEs and ensure that they are tailor-made based on risk assessment to properly address and prevent corruption in specific SOEs that adopt them.
  14. Ensure that Anti-Corruption Commissioners at the SOEs are appointed through open competitions, their qualification is raised on a regular basis, and that they are properly resourced to carry out their duties.
  15. A. As a matter of priority, clarify in law which legal entities and which persons within these entities are covered by the provisions of the Law on Prevention of Corruption.  
B. Ensure that requirement to declare assets by the management of SOEs which are required to do so by law is applied consistently to all of these SOEs. Develop clear guidelines as to which persons within the SOEs should report.  
C. Ensure practical availability of whistle blower protection measures within the SOEs.  
D. Proactively include the Anti-Corruption Commissioners of the SOEs in the trainings organised by NACP and ensure that anti-corruption trainings conducted by SOEs are regular and have a practical nature.  
E. Analyse recorded abuses and relevant criminal corruption cases in the procurement practices of SOEs in order to design specific tools to reduce corruption and to eliminate existing loopholes which allow for corrupt behaviour in this area.
  16. Further strengthen enforcement of SOEs-related criminal cases at all levels, in particular: a. consider undertaking operations sweeping the whole sector or industry to break down the well-established schemes; b. provide NABU and SAPO with necessary resources to do so, including increasing analytical capacity and better access to other official experts; c. update methodological guidelines on most challenging and complicated issues, such as calculation of damages; d. continue and further improve international cooperation in corruption cases that involve SOEs; and, e. follow up on court practice as it develops to identify and address emerging challenges at the stage of adjudication.
  17. A. Ensure that declared plans for reforms in regards to individual SOEs are followed through within the timelines originally identified by the Government. In particular, reform of the flagship SOEs should be ensured to demonstrate true commitment and readiness to reform.  
B. Ensure that the Government's ownership entities effectively communicate and oversee the implementation of the agreed companies' objectives and the SOE governance policy; establish clear lines of communication with the company and avoid multiple layers of decision making.

18. Consider undergoing a comprehensive review of Ukraine's State corporate ownership including the corporate governance of the SOEs by OECD with the view to develop best approaches to address its multiple problems in the current legislative and governance frameworks

Source: OECD (2018), Anti-Corruption Reforms in Ukraine: Prevention and Prosecution of Corruption in State-Owned Enterprises, <https://www.oecd.org/corruption/anti-bribery/OECD-ACN-Ukraine-4th-Round-Bis-Report-SOE-Sector-2018-ENG.pdf>







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