

Fighting Corruption in Eastern Europe and Central Asia

Anti-Corruption Reforms in Ukraine: Prevention and Prosecution of Corruption in State-Owned Enterprises

4th round of monitoring of the Istanbul Anti-Corruption Action Plan

OECD ANTI-CORRUPTION NETWORK FOR EASTERN EUROPE AND CENTRAL ASIA

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This report was adopted at the ACN meeting on 4 July 2018 at the OECD in Paris. It completes the 4th round of IAP monitoring of Ukraine through a special follow-up procedure of bi-monitoring – with the adoption of an outstanding chapter on prevention and prosecution of corruption in state-owned enterprises (Chapter 4).

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ACRONYMS

ACN	Anti-Corruption Network for Eastern Europe and Central Asia
AMC	Anti-Monopoly Committee of Ukraine
CEO	Chief Executive Officer
CoM	Cabinet of Ministers of Ukraine
CoST	Construction Sector Transparency Initiative
EBRD	European Bank of Reconstruction and Development
EU	European Union
IAP	Istanbul Anti-Corruption Action Plan
IMF	International Monetary Fund
IFRS	International Financial Reporting Standards
JSC	Joint Stock Company
LLC	Limited Liability Company
MECI	Ministry of Energy and Coal Industry
MEDT	Ministry of Economic Development and Trade of Ukraine
MLA	Mutual Legal Assistance
MoF	Ministry of Finance
MoJ	Ministry of Justice of Ukraine
MP	Member of Parliament
NABU	National Anti-Corruption Bureau of Ukraine
NACP	National Agency on Prevention of Corruption of Ukraine
NERC	National Commission for Energy and Public Utilities Regulation
NJSC	National Joint Stock Company
NGO	Non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
PM	Prime Minister
RDO	Reforms Delivery Office
RSTs	Reform Support Teams
SAI	Supreme Audit Institution
SAS	State Audit Service of Ukraine
SAPO	Specialized Anti-Corruption Prosecutor's Office
SFS	State Fiscal Service of Ukraine
SPFU	State Property Fund of Ukraine
SOE	State-owned enterprise
TI	Transparency International
UAH	Ukrainian Hryvnia
Verkhovna Rada	Parliament of Ukraine
WB	World Bank

EXECUTIVE SUMMARY

This report presents a general snap-shot of the situation in the State-owned enterprises (SOEs) sector in Ukraine and points out selected key issues and challenges that relate to the integrity of this sector together with a set of recommendations to address them. Each issue of SOEs governance is looked through the “lens of anti-corruption”. At the same time good governance of SOEs in Ukraine is number one prerequisite for eliminating wide-spread corruption and closing loopholes which allow for it. Year 2014 was taken as a baseline, since that year corruption and vested interests have finally been identified by the government as significant factor in SOEs historical underperformance, and the government has announced its clear intention to clean it up.

Sector overview

In Ukraine SOEs comprise a substantial part of the economy, provide key public services, and represent the largest employer in the country. The number of SOEs in Ukraine is very high, with less than half of them estimated as functioning. However, no State agency in Ukraine holds up to date figures. Most of the functioning SOEs are not operating efficiently. Moreover many of them operate at a loss either due to corruption, mismanagement and/or onerous public policy objectives carried out by SOEs. Efforts to reduce their number through mergers, privatisation and liquidation have recently been started but met resistance.

Unfortunately the names of the biggest SOEs are also mired in corruption and political graft scandals. Corruption clearly remains one of the main obstacles to the long-awaited reform of SOEs. Political capture of the SOEs is the overarching theme of corruption related allegations. The same general theme emerges from recent corruption related investigations and prosecutions. Even according to the top government officials SOEs have been used for decades to create corrupt schemes. SOEs are often quoted as the main price in the elections to be divided by quotas after the elections. Members of the SOEs’ management, officials of the relevant ownership entity or political elite members, which have control over the relevant sector, industry, ministry or enterprise, are often either affiliated to or own intermediary firms used in corrupt schemes or receive a part of the profits through kick-backs.

State’s corporate ownership

Currently Ukraine is lacking a strategic document which would identify its ownership rationale and direction of the SOEs sector reform. Ukraine announced its intention to develop such a policy document in 2014 and it was expected to be adopted in 2015. However, in 2018 its adoption was still pending. Ukraine is therefore urged to carefully evaluate and disclose the objectives that justify state ownership, adopt and make them public in a form of a State ownership policy, and subject this policy to a review at regular intervals. This will set the framework for the rest of the reform of the SOEs sector and ensure that it is consistent and serves best interests of the public.

Currently the application of general laws on SOEs in Ukraine is unclear. Instead there is a vast amount of specific regulations, in various degrees of authority and importance, concerning specific enterprises or industries. Ukraine needs to streamline the legislative framework regulating the operations of SOEs, ensuring that SOEs can operate in market environment like private companies. In particular, due to high risk of corruption Ukraine is recommended to incorporate unitary enterprises - a special corporate form exclusively reserved to SOEs - most of which are still under no obligation to have supervisory boards and

do not undergo external independent audit, positioning them totally outside any independent external control) into commonly used corporate forms.

Ukraine's ownership structure of the Government is also not efficient. There is no single specialized and centralized ownership function entity responsible for continuous professional administration of state-owned assets. Instead, there is a large number of owners of different rank (85 only at central government level) and, still worse, a number of various authorities with a right to intervene in the operations and business of the enterprises. They operate as autonomous centres of administration, unable to carry out whole-of-government coordinated ownership policy, and combine multiple roles, such as exercising ownership rights, formulating State policies, regulating, and advocating the interests of the communities that consume the products and services of SOEs. Such a set up results in conflicts of interests, it creates competing objectives and fertile ground for corruption. It also impairs management, performance, control and accountability. Ukraine is therefore recommended to 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.

Numerous reforms have been launched in Ukraine in regards to corporate governance of the SOEs since 2014. However, the proper supervisory boards with independent members have been established only in a very few select enterprises. Furthermore, established supervisory boards seem to be often prevented from carrying out their functions in line with commonly accepted corporate norms and struggle to maintain their independence. CoM has retained in many cases the rights to nominate the CEO and to approve the corporate strategy, financial plans, etc. Ukraine needs to ensure that supervisory boards, with a majority of independent members, are established in SOEs through a well-structured, merit-based and transparent nomination process. Supervisory boards should also be given the necessary powers to exercise their functions without undue interference in their activities. The rights of State authorities to select and appoint CEOs and other executives should be abandoned and the supervisory boards should be authorised to do this through a transparent and skill-based selection process. And finally the CEOs should be insulated from outside pressure and interference in the day-to-day operations of their SOEs.

Currently performance of the SOEs is evaluated through a complicated formal performance control system, which lacks any enforcement leverages and does not provide for efficient and effective analysis and control. Report recommends that Ukraine amend this by ensuring that: (i) SOEs report timely and in full scope on their performance to the ownership entities; (ii) ownership entities perform proper economic and financial analysis and steer their SOEs based on such evaluations; (iii) MEDT receives full information and is able to conduct an in-depth analysis, and (iv) policy, strategic or management decisions regarding the SOEs governance are based on results of performance evaluation.

Financial control over SOEs is conducted through internal audit of the enterprises and external audit performed on one hand by external auditors appointed by the enterprises themselves and on the other hand by several State authorities. Financial control functions performed by the State appear to be a resource heavy and costly system, which is inefficient and slows down or blocks the everyday operations of at least very large SOEs. It poses multiple corruption risks and potential for various abuses. Independent external audit of the biggest SOEs was made mandatory only recently and results of implementation of this requirement are extremely poor. Even fewer SOEs have an effective internal audit than independent external audit. There is still a large number of unitary enterprises with no proper internal and external audit i.e. no control at all. Report therefore recommends Ukraine to provide for effective financial control over SOEs and ensure that audit functions are not used for political or other improper interference in the operations of SOEs.

Privatisation

In 2014 the new Government briefly put privatisations of SOEs on hold in order to review and audit their operations. In 2015 MEDT together with the SPFU developed a catalogue of over 200 SOEs for potential privatisation. Privatisation of major assets was expected to start by the end of 2015. However, in 2016 while Ukraine achieved solid growth, macroeconomic stabilisation, and lower inflation rates, the planned privatisation of SOEs did not take place. Planned sales of SOEs have been postponed repeatedly, prompting investors to question the authorities' commitment to selling valuable but cash-strapped State assets and underlining the need to focus on better preparing of State companies for sale.

Adoption of the new legislation on privatisation in 2018 became definitely a step forward. It changed the conceptual approach to privatisation and to some degree simplified the procedures. New legislation also provided for most privatisations to be done through a competitive bidding process. However, if this law is not rigorously implemented it would undermine Ukraine's credibility and commitment to see through privatisation. Therefore, Ukraine is strongly encouraged to step up its efforts and ensure that its coordinating body, the CoM, rigorously controls implementation of various roles and functions by all bodies involved in the privatisation process. Pre-privatisation and privatisation functions of SPFU should be properly resourced. It will be equally important to implement provisions on prevention of conflict of interest of all participants of the privatisation process to ensure its full integrity. Finally, report also recommends taking other measures to efficiently reduce the number of SOEs, including liquidations, mergers and other restructuring.

Anti-corruption measures

Both the Anti-Corruption Strategy and the Anti-Corruption State Programme contain references to corruption in SOEs and measures to reduce it. The implementation of these measures however remains limited or formalistic. The report recommends Ukraine to ensure that addressing corruption in SOEs finds its proper reflection in the new policy documents, but most importantly that measures designed in the previous documents through 2017 get implemented or transferred into the newly adopted documents.

One of the introduced measures was adoption of anti-corruption programmes in the SOEs. However, even when anti-corruption programmes were mandatory, they were not always introduced. Risk assessment was not used consistently, if at all, with limited guidance and follow up by NACP. Ukraine should therefore ensure that anti-corruption programmes are introduced in all SOEs which fulfil the set criteria and that this is more than a mere box-ticking exercise.

Similarly Anti-Corruption Commissioners were not appointed in all concerned SOEs and mostly without open competitive process. They often perform other functions and approach their anti-corruption duties formalistically. Ukraine is recommended to ensure that Commissioners at the SOEs are in fact competent and qualified to carry out their duties, as well as well-equipped and resourced for performance of their broad functions, and that their status and mission are well communicated to all employees and supported by the management of the SOEs. They should be able to act independently but also be accountable to the Supervisory Board and its audit committee, in addition to the CEOs and NACP. And finally, they should be appointed through open competitions and their qualification should be raised on a regular basis.

Asset declarations of the management and supervisory board members of the SOEs is a good measure from purely anti-corruption point of view. However, the report caveats that they are seldom seen in other economies and put the SOEs in an onerous position vis-a-vis private enterprises. The report also stresses that current requirements need to be applied consistently to all concerned SOEs and clear guidelines should

be developed as to which persons within the SOEs should report. Technical issues to enable such submissions by foreign nationals should be resolved before such a requirement is enforced triggering any sort of a liability. Ukraine needs to address this issue urgently to avoid further misinterpretations and violations of the law.

The Law on Prevention of Corruption provides for whistle-blower protection. The Anti-Corruption programmes of SOEs are also expected to contain such clauses. However, the real availability of such measures should be ensured by the SOEs, but it does not appear to be a common practice at the moment in Ukraine.

It appears that the lines of communication and coordination in regards to anti-corruption trainings organised by NACP can be improved. In addition, NACP should be encouraged to proactively include the Commissioners of the SOEs in their future trainings. Anti-corruption trainings within the SOEs organised by the Commissioners should become regular and be of practical nature.

Corruption in public procurement of the SOEs merits a separate consideration in Ukraine. Most of the existing schemes have been in place for years and in fact the management of many concerned SOEs does not even bother to monitor market prices or provide a well-argued comparative analysis when making purchasing or sales decisions. Most large SOEs have “satellite companies” which win all tenders and do exclusive business with the SOEs. It appears that these schemes are well known, often tolerated and rarely given a closer look. This needs to be changed if fighting corruption in SOEs is to be taken seriously. Procurement practices, recorded abuses and relevant criminal corruption cases should be analysed in order to design specific tools for SOEs to reduce corruption and to eliminate existing loopholes which allow for corrupt behaviour in this area. These tools should be then vigorously applied.

There are already examples of real enforcement in regards to corruption in SOEs. Corruption cases involving SOEs and their officials comprise a quarter of the NABU and SAPO cases. By the end of June 2018 out of 793 criminal proceedings of NABU over 194 dealt with approximately 50 SOEs and their officials. However, this number still does not adequately compare to the total number of allegations of corruption in the sector. Enforcement of these crimes should be further strengthened at all levels. Perhaps operations sweeping the whole sector or industry would help break down the well-established schemes. NABU should be provided with necessary resources, including more analytical capacity and better access to outside official experts. Methodological guidelines on most challenging and complicated issues need to be developed. International cooperation in corruption cases that involve SOEs should be continued and further improved. And finally court practice should be followed up to see what challenges will emerge at the stage of adjudication and how they could be best addressed.

Case-studies

Case-studies look into examples of four select SOEs (Naftogaz, Ukrenergo, Turboatom and Khmelnytskoblenergo) and try to describe how all issues covered in the first general sections find their implementation in each of these SOEs. These four companies are in no way representative of the rest of the SOEs in Ukraine and can be considered flagships of reform in the country. They are among top 25 SOEs but represent different forms of incorporation, operate in several industries and have different ownership entities, which allowed for a comparative overview of reviewed issues in these various contexts.

It is beyond doubt that **Naftogaz** benefited from being the flagship of the corporate governance reform for SOEs and from the adoption and partial implementation of the CGAP. However, success of the reform largely depends upon full implementation of its key elements, such as (i) approval of the strategy; (ii)

approval of the ownership policy in line with the OECD Guidelines; (iii) vesting Supervisory board and executive body of Naftogaz with the due scope authorities in line with best practices of corporate governance; and (iv) resolving issues of dividends, removing abundant inspections and approvals, as well as all other inefficient state controls, and adoption of the required legislation. Its example clearly illustrates that the efforts of the Government to "improve the corporate governance" will remain declarative as long as the general and structural issues have not been reorganized. Absence of political will and commitment cannot be afforded by Ukraine at this point in time and it should follow through on its plans and promises of true corporate governance reforms of the SOEs – Naftogaz is an excellent place to start. It is being watched closely domestically, as well as internationally and has become a test for real reforms.

Ukrenergo appears to be another example of announced plans for corporate governance reform in Ukraine, which are not progressing as fast as envisioned. The ownership entity is encouraged to work towards implementing good practices in the enterprise, such as the establishment of the Supervisory Board. Regulatory functions should be clearly separated from the ownership of the SOE and necessary adjustments need to be made towards this end. Corporatisation of Ukrenergo and abandoning the corporate form of unitary enterprise will be a big step forward but it should also be finalised keeping to the determined timelines.

Khmelnyskoblenergo contributes to the impression that the Government does not have a clear vision as to where it is going in regards to its SOEs. Reforms are being announced and then left pending. In the case of Khmelnyskoblenergo it appears that its management is operating under many uncertainties, its status is not confirmed, the Supervisory Board independent members are not yet appointed and most importantly since the announcement in 2015 of the eventual privatization, the Company is still not clearly informed on when this would happen and what form of privatization is going to be pursued. The obligatory dividend rate applied to all SOEs continues to have no regard to the profitability and financial position of the companies. In Khmelnyskoblenergo which has other shareholders this issue becomes even more acute and requires prompt attention and resolution.

Turboatom is one of the companies in regards to which numerous reforms have been announced. All of this is forthcoming very slowly. Efforts of the State in this regard need to be clearly stepped up. In particular, independent members of the Supervisory Board should be selected and appointed, and it should start operating in accordance with international good practices and OECD Guidelines. The obligatory dividend rate applied to all SOEs also requires prompt attention and resolution in the case of Turboatom.

In sum, Ukraine first and foremost should reduce the huge number of SOEs; the government should issue an ownership policy; reduce the number of ownership entities and find the way forward towards a single ownership entity. Corporate forms reserved to SOEs only should be abandoned and the unitary enterprises should be incorporated. Anti-corruption tools should be made effective rather than formalistic. Ukraine should also ensure that declared plans for reforms in regards to individual SOEs, in particular flagship SOEs, are followed through within the timelines originally identified by the Government. The Government's ownership entities need to effectively communicate and oversee the implementation of the agreed companies' objectives and the SOE governance policy. Clear lines of communication with the company should be established to avoid multiple layers of decision making. And finally, Ukraine is encouraged to undergo a comprehensive review of its 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 institutional frameworks.

4.1. Introduction

The 4th round of monitoring includes one novelty: an in-depth examination of a specific sector with a high risk of corruption. ACN countries have agreed that the in-depth evaluation of a selected sector will examine the practical application of the anti-corruption policy as well as the prevention and enforcement measures in this sector.

In Ukraine, the prevention and prosecution of corruption in state-owned enterprises (SOEs) was selected as the sector for in-depth review and is meant to be covered in this Chapter. Case-studies of four SOEs, NJSC Naftogaz of Ukraine, NPC Ukrenergo, JSC Turboatom and JSC Khmelnytskoblenergo will be reviewed as part of this Chapter to provide a more in-depth look into company level situations.

While the sector has been selected in consultations with the Government of Ukraine, the cooperation of the authorities on preparation of this Chapter was not in line with the requirements of the IAP methodology for the 4th round of monitoring during 2017 when information for the monitoring report and this Chapter was collected. The information provided to the monitoring team of Chapter 4 was not complete, often not in the language of the evaluation and the reference documents were not made available. Therefore the monitoring team could not address some of the key issues that have direct impact on the creation of possible corruption risk factors, such as corporate forms of SOEs (joint-stock companies vs unitary enterprises), enforcement efforts in the sector, key preventative measures, practices for corporate management reforms foreseen in the legislation, etc. This prevented the monitoring team from making meaningful findings or drawing grounded conclusions on the situation in the SOE sector in regards to corruption, as well as in regards to actual practical application of anti-corruption measures in the sector.

As a result the report was adopted on 14 September 2017 without this Chapter and a special follow up procedure - bis-monitoring of prevention and prosecution of corruption in state-owned enterprises - was applied to Ukraine to ensure proper completion of the 4th round of monitoring.

The bis-monitoring procedure was launched for Ukraine in 2018 with filling out of new questionnaires by all relevant stakeholders, including the Government and the selected SOEs. Civil society, private sector and international partners have been also consulted when drafting of this report.

The monitoring team comprises of Mr Arto Honkaniemi, former Senior Counsellor of the Ownership Steering Department at the Prime Minister's Office of Finland and a former delegate of Finland to the OECD Working Party on State Ownership and Privatisation Practices, Ms Tanya Khavanska, Legal and Policy Analyst of the Anti-Corruption Division and Projects Manager at the Anti-Corruption Network for Eastern Europe and Central Asia, OECD, and Ms Antonina Prudko, Anti-Corruption Advisor, OECD Anti-Corruption Project for Ukraine. The report has benefited from comments from colleagues of the Corporate Affairs Division of OECD, namely, Sara Sultan, Policy Analyst of the Corporate Affairs Division of OECD.

The on-site visit took place on 16-20 April 2018 and was primarily organised with the assistance from State Property Fund of Ukraine (SPFU), which provided the venue, helped set up meetings and invite key interlocutors. In total 16 sessions were held with various government agencies, SOEs, civil society, auditors and other representatives of private sector and international organisations and embassies.

SPFU has also provided support in translating reference documents for the monitoring team and coordinated collection of responses to the questionnaires and comments to the draft report from two of the SOEs. The monitoring team would like to express their gratitude to the Government of Ukraine for its

effective co-operation during this bis monitoring and, notably, to officials of the SPFU. The monitoring team is also grateful to Ukrainian authorities, representatives of the SOEs and non-governmental representatives for open and constructive discussions that took place during the country visit; to the EBRD and Embassy of Norway for providing valuable insights.

This report was prepared on the basis of the government of Ukraine's answers to the questionnaires, the monitoring team's findings from the on-site visit, additional information provided by the government of Ukraine, SOEs and non-governmental partners. Information from other publically available sources was also used during the preparation of the report, as well as relevant information received during the plenary meeting.

Despite the big volumes of information made available to the monitoring team, the sector of SOEs in Ukraine is too large to be fully covered in this monitoring. However a general snap-shot of the situation in the sector has been made with the attempt to point out a few selected key issues and challenges that relate to the integrity of this sector, together with a set of recommendations to address them.

The report was adopted at the ACN Istanbul Action Plan plenary meeting in Paris on 4 July 2018.

The report is made public after the meeting, including at www.oecd.org/corruption/acn. Authorities of Ukraine are invited to disseminate the report as widely as possible and, in particular, to translate it into national language. To present and promote implementation of the results of the bis-fourth round of monitoring the ACN Secretariat will organize a return mission to Ukraine, which will include a meeting with representatives of the public authorities, civil society, business and international community. The Government of Ukraine will be invited to provide regular updates on measures taken to implement recommendations at the Istanbul Action Plan plenary meetings.

The fourth round of monitoring under the OECD/ACN Istanbul Anti-Corruption Action Plan is carried out within the ACN Work Programme for 2016-2019 that is financially supported by Latvia, Liechtenstein, Lithuania, the Slovak Republic, Sweden, Switzerland and the United States.

4.1.1. Background

SOEs play an important role in the ownership landscape and in global markets. In many economies they are the main providers of key public services, such as electricity, transportation, water, telecommunications and postal services. The efficient performance of SOEs has a strong and direct impact on the everyday life of the citizens. How well the SOEs are governed has a significant impact on their performance and value, as well as on public finances, economic growth and competitiveness.

Governments face complex challenges in improving the governance of their SOEs. These challenges include among others introducing appropriate accountability and transparency processes. SOEs which are transparent and accountable are more likely to conform to the rule of law, including respecting shareholders and stakeholders rights. They enjoy higher levels of public trust and have better access to capital at lower cost. It is only with such systems that the state will be able to act as an informed owner, without interfering in day-to-day management, and to address any existing or potential corruption risks. Furthermore, greater transparency is usually very effective in triggering further support for reforms.

In Ukraine SOEs comprise a substantial part of the national economy and provide key public services, including electricity, gas, water, transportation and postal services. They also represent the largest employer in the country. Unfortunately also in Ukraine the names of the biggest SOEs are mired in

corruption and political graft scandals. Its SOE landscape is influenced by the need for massive scale privatisation and the role of the State as an owner needs to and has been undergoing fundamental changes.

The OECD has been a standard setter on the issues of governance of SOEs, as well as on anti-corruption measures that should be put in place to reduce the levels of corruption. This Chapter aims to look at the SOEs sector from the anti-corruption perspective, bringing together the OECD and other international standards and good practices in these two areas. It ultimately attempts to cover the relevant accountability and transparency recommendations of the OECD Guidelines on Corporate Governance of State-Owned Enterprises (OECD Guidelines). While the Chapter touches directly or indirectly upon all Guidelines, special attention is paid to Disclosure and transparency (vi), Rationales for state ownership (i), The state's role as an owner (ii), and The responsibilities of the boards of the state-owned enterprises (vii). The general logic of the IAP monitoring is also followed by the Chapter.

Since the IAP monitoring is looking into the issues of corruption in the SOE sector for the first time, the report focuses on the situation in the SOE sector of Ukraine from 2014 onwards to provide an overtime context of the progress, while keeping the information relevant.

The report is structured in the following way:

Introduction Section 4.1 covers methodology, general background on the issue of SOEs and corruption challenges in this sector, as well as provides a general overview of this sector in Ukraine and identifies various corruption-prone issues within this sector.

State's Corporate Ownership Section 4.2 looks into the governance at the state owned enterprises: it strives to cover current legislative framework and to the extent possible how things work or do not work in practice. This section looks into a broad range of issues, including policy, legal and institutional frameworks, governance of the individual SOEs, control over their activities, their accountability and transparency. The attempt is made to look at the general picture and identify what gaps and problems in the existing system should be addressed in order to reduce or eliminate potentials for corruption.

Privatisation Section 4.3 looks into privatisation process in Ukraine, including current legal and institutional framework, methods of privatisation and other methods to reduce the number of SOEs. Again it attempts to identify those elements which need to be "fixed" to ensure corruption-free privatisation in Ukraine.

Anti-Corruption Measures Section 4.4 covers a broad range of measures and follows the structure of IAP general report. It includes policy, institutions, preventative measures and enforcement of criminal law. Again the section attempts to describe what the law requires and how this is then translated into practice.

Case-study sections 4.5-4.8 look into examples of four select SOEs and try to describe how all issues covered in the first four sections find their implementation in each of these SOEs.

It should be noted that this report does not attempt to review Ukraine against the SOE Guidelines even if the Guidelines are referred to as a standard of good practice and shall not prejudice the outcomes of any future corporate governance review. Instead an attempt is made to look at each issue of SOEs governance through the "lens of anti-corruption". At the same time good governance of SOEs in Ukraine is number one pre-requisite for eliminating wide-spread corruption practices and closing loopholes that invite corrupt opportunities.

4.1.2. Sector overview

State portfolio

The number of SOEs in Ukraine is very high: in 2017 the SOE sector in Ukraine comprised of 3 444 enterprises¹. To compare, the largest SOEs sectors in OECD countries are in post-transition economies, with Hungary's 370, the Czech Republic's 133, Lithuania's 128, Poland's 126 and the Slovak Republic's 113 SOEs. Ukraine's number is impressively high even if compared to large emerging market economies such as India with its 270 SOEs and Brazil with its 134 SOEs.² However only approximately 1 700 of these 3 444 SOEs are estimated to be functioning.

This number of 3 444 SOEs, administered by 85 governing entities, is still not exact. No State agency in Ukraine holds up to date figures of the number of SOEs. The Registry of the State Property Objects, administered by the State Property Fund of Ukraine (SPFU) includes only SOEs incorporated in the corporate forms of joint-stock company (JSC) or limited liability company (LLC). However the vast majority of Ukrainian SOEs have been established as unitary enterprises, a specific corporate form reserved for state-ownership only. Further, there is no mechanism to ensure that all governing entities provide information in regards to their SOEs. SPFU has shared with the monitoring team that the Registry is being filled out based on information sporadically provided by governing entities on their own volition and SPFU cannot follow up, check or require these governing entities to do it on a regular basis. The Ministry of Economic Development and Trade of Ukraine (MEDT), which logically should assume the responsibility of collecting integral information and data, also confirmed that they do not have the exact figures and they make efforts to collect information by reaching out to various governing entities.

It should be also mentioned that the cited number of 3 444 represents only the companies governed by the central level State bodies. Various figures from 8 000 and more have been provided in regards to the enterprises which are governed by entities at the municipal and local level, but no verifiable information is available.

In 2016 the SOEs employed over 847 thousand people, the total value of assets comprised UAH 1 441 billion and the annual revenue amounted to UAH 450 billion. The Top 100 SOEs accounted for about 80 percent of the total assets and 80 percent of the total revenue. At the end of the first half of 2017 the value of assets went up 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. 51 % of this revenue has been generated by companies in the oil and gas industry, in particular by Naftogaz. Its revenues have increased by 41% in comparison with the first half of 2016. SOEs in the energy and transportation sector have also brought in 20% of the general revenue. Only chemicals and food and agriculture sector SOEs have seen a decrease in their revenues in the first part of 2017.³

¹ Data is taken from the official website of the Ministry of Economic Development and Trade, May 2018.

² OECD (2017), *The Size and Sectoral Distribution of State-Owned Enterprises*, OECD, Paris.

³ Data is taken from the TOP-100 State-Owned Enterprise report for first 6 months of 2017.

Table 1: SOEs in Ukraine – comparative data from 2013-2017

year	GDP (UAH billion)	Net revenue (UAH billion)	%	Quantity of SOEs			Employed people (in thousand)		
				SOEs total	SOEs functioning	% SOEs functioning	Total	SOEs	% SOEs
2013	1495,2	279,8	18,7	3632	2109	58,1	9729,1	1112,3	11,4
2014	1586,9	376,9	23,8	3338	1829	54,8	8796,7	930,0	10,6
2015	1988,5	442,7	22,3	3458	1801	52,1	8331,9	849,3	10,2
2016	2383,2	590,8	24,8	3435	1770	51,5	n/a	847,0	n/a
1Q17	n/a	190,2	n/a	3421	1715	50,1	n/a	820,5	n/a

The top 91⁴ SOEs represent the following industries according to the data of the Ukraine’s TOP-100 State-Owned Enterprises report for the first 6 months of 2017: oil and gas, transportation, energy, food and agriculture, machine building, chemicals and coal mining.

The biggest SOEs in these sectors are the following:

- Oil and gas sector: “Naftogaz” (national oil and gas operator) and its subsidiaries;
- Transportation sector: “Ukrzaliznytsia” (railways), “Sea port administration” (maintenance of sea ports), “Boryspil” Airport;
- Energy sector: “Energorynok” (energy market), “Ukrhydroenergo” (hydro power generator), “Energoatom” (nuclear energy generator);
- Food and agricultural sector: “State Food & Grain Corporation” (grain trader);
- Machine building sector: Construction bureau “Pivdenne” (rocket developer), “Turboatom” (turbine producer);
- Chemicals sector: “Odessa Portside Plant” (nitrogen fertilizer producer).

During the on-site visit Ukrainian authorities and other interlocutors informed the monitoring team that most of the SOEs are not operating efficiently, moreover with many of them continuing to operate at a loss either due to corruption, mismanagement and/or onerous public policy objectives carried out by SOEs. SOEs are also holders of non-current assets with little or no relevance to their proper businesses and operations such as hotels, holiday resorts and restaurants. A Naftogaz subsidiary, for example, was mentioned to own a sausage factory.

⁴ 6 banks owned by the state and 3 SOEs for which reporting information was missing, have not been taken into account.

Table 2: Revenue vs losses of top SOEs for 2014-2016

SOE	Net profit gained from selling products (goods, works, services), million, UAH			Net financial gain, million, UAH		
	2014	2015	2016	2014	2015	2016
“Energorynok”	90 548,5	109 405,9	131 022,3	21,8	1 672,2	1 283,5
“Ukrzaliznytsia”	0,0	60 126,0	66 570,0	0,0	-16 842,0	-7 322,0
“State-owned Grain Products Corporation”	7 054,0	12 418,4	13 089,0	-1 497,5	-3 029,5	-766,0
“Naftogaz”	74 412,1	131 248,0	192 764,0	-89 954,1	-36 323,0	22 532,0
“Energoatom”	23 237,7	32 903,9	36 903,9	-6 494,4	1 168,2	187,0

Since 2014 the Ministry of Economic Development and Trade (MEDT) has maintained that the Government does not have the expertise or capacity to manage such a large portfolio efficiently or invest in the SOEs in a proper manner. Most other government and non-government interlocutors met at the on-site expressed similar opinions. Only the sheer number of units is overwhelming and impossible for any government to oversee. Efforts to reduce the number of SOEs by merging of existing SOEs and creating vertical/horizontal integrated SOEs, by privatization and liquidation of the non-functioning or otherwise obsolete units have recently been started but these efforts have been met with resistance.

Prevalence of corruption in the SOE sector

In its second report on Ukraine’s 100 largest SOEs, released in 2014, MEDT reported the highest losses of the SOEs amounting to UAH 117 billion. The report identified mismanagement, vested interests and plain corruption in the SOE sector as underlying causes.⁵

Namely, the report stated that corporate governance standards in the SOE sector posed serious corruption risks due to a lack of proper supervision and this exposed the enterprises to political interference. That report provided a good base-line in identifying special areas of concern and highlighted following main issues with regard to SOEs playing a role in the prevalence of corruption:

- Lack of separation of ownership from regulation;
- Management loyal to vested interests;
- Lack of competitive and independent selection process for Supervisory board and CEO nominations;
- A remuneration system that incentives corruption rather than dissuade it.

In particular, according to the report subordination of SOEs to individual ministries was on one hand shielding them from outside competition and providing them with other “beneficial treatment”. On the other hand these ministries often took active part in the direct management of the SOEs, which resulted in conflicts of interest and goes against internationally agreed practices.

One of the tenants of the OECD Guidelines - which is the only internationally-agreed instrument on good governance of SOEs - is that the state ownership functions should be separated from regulation. Most

⁵ Ukraine’s TOP-100 State-Owned Enterprises, Full Year 2014.

ministries and other central administrative bodies have not separated these two roles. It is recommended that to avoid conflicts of interest, the State's ownership function should be clearly separated, or operated at arm's length, from a ministry or other administrative body having regulatory tasks.

The report also stressed that the old management of SOEs was often kept with vested interests by various political forces and was resisting the change introduced by the new mechanism for transparent selection of CEOs for the state-owned companies. New appointments were not forthcoming and the quality of candidates was low. In addition, this was in parts due to the old remuneration system which didn't allow paying market level salaries to the CEOs.

Clearly corruption in SOEs long predates 2014 and has likely been in place in most of these enterprises since their set up and took new, sometimes more aggravated forms, when they have been corporatized. However, it is in 2014 that corruption and vested interests have finally been identified by the government as significant factor in SOEs historical underperformance, and the government has announced its clear intention to clean it up. The Minister of MEDT at the time of the 2014 report on Ukraine's 100 largest SOEs, Aivaras Abromavicius, pledged to evaluate the performance of SOE management and to minimize the risk of corruption and political interference in the SOE sector.

Unfortunately, the same minister two years later resigned from office in the midst of corruption scandals related to SOEs, making public statements that his decision was motivated by unwillingness to provide cover to the corrupt schemes related to SOEs and because he was unable to perform his functions under continued political pressures and undue interferences.⁶

While some reforms have taken place in the sector of SOEs and will be further elaborated upon in this report, most of the concerns of the 2014 MEDT report remain relevant in 2018 and need to be addressed.

In January 2018 Ukraine's Prime Minister, Volodymyr Groysman, told the Parliament before the vote on the new Law on Privatisation that "the largest sector of corruption today is state-owned enterprises, which have been used for decades to create corrupt schemes".⁷

Political capture of the SOEs is the overarching theme of corruption related allegations. The same general theme emerges from recent corruption related investigations and prosecutions. SOEs are often quoted as the main price in the elections: "SOEs are divided by quotas after the elections, with a fight for even "loss-making enterprises" because "profits" made on them by-pass the budget."⁸

The most common corruption schemes that have been quoted both by various interlocutors met at the on-site visit and in the press are (i) purchase of goods and services for SOEs at prices which are higher than market prices, i.e. public procurement abuses, and (ii) 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 both cases - members of the management of the SOE, or officials of the relevant ownership entity, or members of the political elite having control over the relevant sector, industry, ministry or enterprise, are either affiliated to or own this intermediary firm, or receive a part of the profits through kick-backs.

⁶ BBC, 3 February 2016 <http://www.bbc.com/news/world-europe-35481699>

⁷ Reuters, 18 January 2018 <https://www.reuters.com/article/ukraine-privatisation/update-1-ukraine-passes-privatisation-law-needed-for-imf-aid-idUSL8N1PD3LS>

⁸ Tyzhden, 3 March 2017 <http://tyzhden.ua/Economics/186642>

Procurement is open for abuse by management of various levels, including middle management. Prevalence of corruption schemes is well described in annual reports of anti-corruption law enforcement bodies. NABU reports emphasize that poor state structures for the oversight of SOEs as well as weak governance and management systems have led the way for politicians and public officials to intervene improperly in the management of SOEs and opened the door for bribery, misappropriation and stealing of assets as well as other forms of corruption. Corruption clearly remains one of the biggest challenges and appears to be one of the main obstacles to the long-awaited reform of SOEs.

Recommendation 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.

4.2. State's Corporate Ownership

Establishing a viable state ownership means that the state acts as an active owner of public assets. The state, through its institutions, sets operational and financial goals for companies demanding effective operations and sound results. The state as the owner however should not intervene directly in corporate activities which should remain the responsibility of the supervisory board, appointed by the owner, and of the top management, appointed by the supervisory board.

4.2.1. Policy Framework

According to the OECD Guidelines the state should exercise ownership of the SOEs in the best interests of the general public and should carefully evaluate and disclose the objectives that justify state ownership. It should also subject these objectives to a regular review. The role of various state bodies in the governance of SOEs should also be clearly defined. SOEs often compete with private businesses; hence the Government must adhere strictly to the principle of separation of ownership and regulatory functions in setting up its ownership structure. In Ukraine, to achieve these goals, MEDT announced its intention to develop an ownership policy in 2014.

The policy was intended to define the principles of how public authorities should exercise the ownership rights entrusted to them. It was to define the separation of regulatory and ownership functions and also to outline corporate governance issues such as methods of determining the remuneration of members of supervisory boards and the principles according to which members of supervisory boards are appointed. It was expected to be adopted in 2015 but has not yet materialized to this date.

Representatives of MEDT shared with the monitoring team a draft document named "Basic principles - introduction of property policy for state-owned enterprises". The document was reportedly drafted by the Reform Support Team of MEDT with the assistance from the EBRD and the WB. It is currently undergoing the approval process within the departments of MEDT.

The draft shared with the monitoring team contains 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 draft Principles, ownership entities having ownership rights in enterprises of particular importance, i.e. assets exceeding UAH 2 billion or annual revenue exceeding UAH 1, 5 billion, should draft and disclose company-specific objectives regarding these particular enterprises.

The ministry aims to have this comprehensive document approved by CoM and adopted in June 2018. However it appears that consultations with various stakeholders which would be affected by this strategic policy have not taken place. Good practices, including those highlighted by the OECD Guidelines, emphasize the importance of consultations to ensure a broader buy-in, and ideally better implementation.

Regardless of all the work done on drafting and promoting the adoption of the strategic document, it is of concern that the Government has not yet issued an ownership policy. Ideally any future ownership policy should cover the following areas: why is the Government owner of enterprises and what is it going to do about them and then publish this paper, subject to review and update from time to time.

Recommendation 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.

4.2.2. Legal Framework

The general legal status and operations of SOEs are governed by laws and regulations which are applicable across all industries, private as well as publicly owned, including the Civil Code of Ukraine, the Economic Code of Ukraine, , the Law on Joint Stock Companies.. In addition, there are various laws and regulations which apply to all economic sectors, as well as those that apply to specific sectors, specific types of SOEs and individual SOEs.

The Law on Management of State-owned Assets and the Law on Privatisation of State-owned Property have recently been reviewed.

Due to the absence of clear guidance on the criteria and scope of the public sector operations in the legislation, SOEs continue to be established and operated regardless of feasibility. Absence of coherent legislation on incorporation and operations of public sector entities results in existence of various legal forms which often do not correspond to the operating models of the entities.

The SOEs are also regulated by different frameworks which make it challenging to introduce consistent governance practices. It appears that no clear steps towards systemizing of the legislative framework governing the existence, governance and operations of the SOEs have been taken.

Forms of incorporation

There is no one-fits-all model form of incorporation of SOEs in OECD countries. OECD Guidelines

recommend that governments simplify and standardise the legal forms under which SOEs operate, and recommend that their operational practices should follow commonly accepted corporate norms. This is in particular relevant to SOEs that engage in economic activities in competition with private enterprises. Governments should avoid creating specific legal forms or granting SOEs privileged statuses or special protection, when this is not absolutely necessary for achieving the public policy objectives imposed on the enterprises.

The Commercial Code of Ukraine defines SOEs as entities of the public sector in which the State holds an interest of over 50 percent or can exercise the ultimate influence over the enterprise's operations.

SOEs may be established or exist in a variety of legal forms, including the following:

- State-owned unitary enterprise, operating as a state-owned commercial entity or as a budget-supported entity;
- Joint-stock company (private and public);
- Subsidiary with State ownership;
- State-owned business association;
- Other types of entities, such as limited liability companies.

As mentioned before no single agency in Ukraine holds full up to date information in regards to the SOEs, including their forms of incorporation. It is therefore not possible to have a precise total number of unitary enterprises, JSCs, LLCs and others.

Unitary enterprises

According to the information provided to the monitoring team there are 325 entities incorporated as joint-stock companies and 87 as limited liability companies but more than 2 000 enterprises are organized as unitary enterprises. This is a specific form of incorporation, available to state-owned entities only. The OECD consensus recommends that state-owned entities be established under the same forms of incorporation as are available for private businesses, within the same legal framework. Unitary enterprises in Ukraine are established by a simple deed by the relevant State authority. Moreover the assets of unitary enterprises remain in the ownership of the State and thus these enterprises have no legal ownership over the assets in their custody. Consequently they cannot use these assets as collateral for borrowing, which essentially limits the available alternatives for financing.

Until very recently unitary enterprises in Ukraine had no obligation to have supervisory boards or external independent audit. The director of each enterprise was to communicate directly with the ministry or other ownership entity. This positioned such enterprises totally outside any independent external control, which created opportunities for corruption and rule breaking that went largely undetected.

The CoM Resolution #390 adopted in June 2015 requires entities with a value of assets exceeding UAH 2 billion or with net income exceeding UAH 1.5 billion to undergo annual external audit. Further in March 2017 CoM made it mandatory for unitary 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, to establish supervisory boards with at least two committees (audit committee and appointment and

remuneration committee).⁹ The procedure for establishment of such supervisory boards is stipulated by the CMU. The majority of the members of such boards should be independent members.¹⁰

This is a welcome development and, if implemented, it will ensure better levels of transparency and accountability. However, it appears that there are only approximately 80 enterprises fulfilling the criteria set by the CoM Resolutions. It is not yet clear how many of the existing over 2000 unitary enterprises have already implemented this new requirement and how this issue can be enforced keeping in mind various concerns raised in the report in regards to the Government's ability to manage the large number of its SOEs.

Monitoring of implementation of this requirement will also be a challenge. The CoM resolution requires the ownership entities to report to MEDT on the setting up of supervisory boards in enterprises of particular importance, including unitary enterprises, on a quarterly basis but there is no guarantee that many of them will fulfil this requirement. In March 2017 MEDT circulated a letter regarding the obligation to set up supervisory boards and external audit to a total of 80 ownership entities. By September 2017, 46 entities had replied with only six entities reporting on the establishment of supervisory boards in enterprises under their responsibility and 40 entities informing MEDT that such measures are not necessary or timely.

In conclusion, the monitoring team finds that the application of general laws on SOEs is unclear. Instead there is a vast amount of specific regulations, in various degrees of authority and importance, concerning specific enterprises or industries. The Government of Ukraine needs to streamline the legislative framework regulating the operations of SOEs, ensuring that SOEs can operate in market environment like private companies.

Recommendation 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.

4.2.3. Governance framework

Ukraine continues to have no single specialized and centralized ownership function entity responsible for continuous professional administration of state-owned assets. Instead, there are at present over 85 ownership entities, operating as autonomous centres of administration, unable to operate under a whole-of-government coordinated ownership policy.

According to the 2014 TOP 100 SOEs report, MEDT conducted a feasibility study to assess whether the centralization of the ownership into a state-owned holding company would be a suitable approach towards improved administration of SOEs in Ukraine. The results of this study and the actions, if any, that have followed, have not been shared with the monitoring team.

⁹ CoM Resolution 142 from 10 March 2017

¹⁰ Article 11-2 of the Law on Management of the State-owned property.

Currently ministries and other State authorities administer state-owned enterprises and combine multiple roles, such as exercising ownership rights, formulating State policies, regulating, and advocating the interests of the communities that consume the products and services of SOEs. Such a set-up results in conflicts of interests that create multiple and competing objectives. They also impair management, performance, control and accountability, especially taking into account that the administration of SOEs is not the core function of these authorities and they often pursue short-term objectives of maximizing fiscal revenues.

Box 1 – Rights of the owner

Pursuant to Article 6 of the Law On Management of State-Owned Objects the ownership entities:

- make decisions on establishment, reorganization and liquidation of state-owned enterprises, establishments and organizations;
- approve statutes of the enterprises, establishments and organizations under their management, and business structures, and conduct control over compliance to them;
- appoint to their positions and dismiss the CEOs of the state-owned unitary enterprises which do not have a supervisory board, of establishments, organizations, and economic structures, with more than 50% of shares in their statutory capital owned by the State, and without a supervisory board, conclude and terminate contracts with them and conduct control over compliance with the terms of the contracts;
- secure the appointment of independent members of the supervisory boards of the state-owned unitary enterprises and business partnerships with more than 50% of shares in their statutory capital owned by the State;
- make decisions, in cases foreseen under the legislation of Ukraine, concerning either giving permission for the state-owned unitary enterprises to run economic obligations of interest and substantial economic obligation, or rejecting such a permission, and take responsibility, set by legislation of Ukraine, for these decisions;
- approve strategic plans for development of state-owned unitary enterprises and business partnerships, with more than 50% of shares in their statutory capital owned by the State, and corporate rights of which and control over which activity are conducted by them, and conduct control over fulfilment of the plans;
- approve annual and investments plans, as well as medium-term (3-5 years) investment plans for state-owned unitary enterprises and business partnerships under their management, and conduct control over the fulfilment of the plans in compliance with the proscribed procedure;
- carry out monitoring of financial activity, inter alia, fulfilment of indexes of financial plans of enterprises, under their management, and take measures for improving their fulfilment;
- secure conducting annual independent audits of financial statements of the state-owned unitary enterprises and business partnerships with more than 50% of shares in their statutory capital owned by the State.
- approve concluding contracts on conducting independent audits of financial statements of the state-owned enterprises under their management and which have no Supervisory board formed;
- take records on the state-owned objects under their management, conduct control over effective exploitation and safety of such objects;
- define candidates of persons presenting interests of the State at the general meetings and at the

Supervisory Boards of business partnerships, functions of state corporate rights management of which they perform, as well as at the Supervisory Boards of state-owned unitary enterprises, secure their appointment, grant Powers of Attorney for presenting interests of the State at the general meetings of such business partnerships to the representatives of the State, and when necessary conclude contracts of commission with them;

- define candidates for positions of the independent members of the Supervisory Boards, in compliance with the procedure set by the Cabinet of Ministers of Ukraine, that are proposed to be appointed for the Supervisory Board of the state-owned unitary enterprises and business partnerships with more than 50% of shares in their statutory capital owned by the State, functions of management of which they perform.

Ownership entities

As mentioned earlier, at present there are 85 ownership entities at the central level of government and the section below will review only a few of them.

The CoM has a steering role in the administration of SOEs. In particular, it assigns responsibility over state-owned assets to line ministries and other public authorities and regulates the procedure for such assignment. It approves the list of strategically important SOEs and also has powers to decide on establishment, reorganization and liquidation of SOEs and assigns supervisors for these processes. Additionally it sets performance criteria for the management of SOEs and decides on the process of application of these criteria. It also issues regulations on various processes which relate to governance of the SOEs, as well as various resolutions in regards to broader strategic issues. Additionally the CoM exercises the ownership rights in select, presently 12 SOEs.

Despite such broad powers of the CoM, some with a conflicting nature, they appear to be not sufficient for ensuring an effective system of coordinated state-owned assets administration. The main issue regarding the role of CoM continues to be that in addition to its wide regulatory it acts as the owner of certain SOEs, instead of taking the responsibility for the development of the State policy.

MEDT is the central executive 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 corporate rights held by the State, which appears to be to some extent duplicating the CoM function. Together with the Ministry of Finance it is responsible for the formulation and implementation of the State dividend policy. It is responsible for the control over the performance of other ownership entities in their ownership role by monitoring the performance of the state-owned enterprises. Additionally MEDT identifies the state-owned enterprises that are not subject to privatization. It has 335 SOEs under its own direct responsibility.

MEDT appears to be struggling with exercising 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 organization three times only since November 2015. According to the Accounting Chamber's report, the ministry's functions which relate both to the development of policies on management of SOEs and to the management and monitoring of SOEs are consistently underfunded: on average they receive around 55 percent of the requested funding.

Management of the SOEs where MEDT exercises the ownership rights has also been ineffective. In 2016 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.

In addition to CoM and MEDT, **ownership entities** in Ukraine include line ministries, other executive authorities, and national collective bodies. At the central government level in connection with the reorganisation of the bodies of central authority the number of such entities has been reduced from 90 to 85, which is still very high. They exercise the ownership rights according to the Law on Management of State-Owned Objects explained herein above. It may be noted that any ownership entity, if it has the necessary means, is authorized to establish new unitary enterprises, without any approval by the CoM or any other higher authority.

The results of the management of SOEs by these entities are no better than those under the direct supervision of the MEDT. In fact according to the findings of the evaluation performed by MEDT, the number of 2109 functioning SOEs in 2013 has dropped to 1770 SOEs in 2016. Moreover, of these 1770 functioning SOEs in the beginning of 2017 – 496 SOEs have been operating at a loss, which amounts to 28% from the total number, as compared to 33% in 2013. In general, the performance of the SOEs is overall lacking and is on a negative dynamic.

MEDT evaluates how effectively the other ownership entities manage their SOEs and has concluded that only 25 ownership entities performed well in this respect in 2013. In 2016 this number had fallen to 23. The performance of 41 ownership entities was evaluated as satisfactory in 2016 and 17 ownership entities had performed in an unsatisfactory manner.

Each year MEDT has consistently reported that the ownership entities do not hold relevant information and data concerning their SOEs, and do not provide such information to the Ministry in full. Therefore the ownership entities, and ultimately the State, do not know what is happening in the SOEs and how these perform. As an example in 2014 the Ministry of Agriculture provided MEDT with data on the financial plans of 470 of its SOEs. Information on the performance of the enterprises according to these plans was only provided in regards to 366 of these entities.

The State Property Fund of Ukraine (SPFU or "the Fund") was established in 1991 for the execution of the State's policy of privatization of SOEs and other State assets. For the time being it exercises direct ownership over 313 SOEs, to be privatized sooner or later. SPFU exercises its ownership rights with the purpose of making the assets to be privatized more attractive to buyers improving their governance, financial planning, accounting, reporting etc. SPFU appoints its employees as chairs or members of supervisory boards of these enterprises representing SPFU as the sole or main shareholder. Additionally SPFU is responsible for the establishment and maintenance of the Unified Register of State-Owned Property.

The ownership structure of the Government is not efficient. There is no centralized ownership function but instead a large number of owners of different rank and, still worse, a number of various authorities with a right to intervene in the operations and business of the enterprises.

Recommendation 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.

4.2.4. Reform efforts (present reform programmes and groups)

Already in 2014 the Government of Ukraine had identified the need for major reforms in the SOEs sector. The OECD Guidelines were to be followed and the envisioned reform was going to focus on setting of

clear objectives when establishing an ownership policy and reforming management policies, separating regulation and ownership, separating the commercial and non-commercial functions, introducing a new model of corporate governance of SOEs, including appointment of supervisory boards, and development of remuneration schemes for board members and top managers. All of this was to be further enhanced by ensuring transparency. MEDT became the flagman for these reforms.

Reform Support Teams (RSTs) are groups of professionals from outside the Ukrainian public service working in certain pilot ministries on a temporary basis to implement priority reforms. The RSTs are financed by the EBRD and the European Union. The RST working under MEDT has the State property management as the key deliverable. This reform includes the optimization of the portfolio of SOEs, a privatization reform, facilitation of the liquidation of non-operational SOEs, corporate governance and innovation development. This RST has primary responsibility over the preparation of the draft ownership policy, "the Basic Principles" mentioned herein above. This group is also operative in the update of the so called Triage files, dividing the Ukrainian SOEs into three groups: those to remain in State ownership, those to be privatized and those to be liquidated.

This RST works closely, and upon approval of the MEDT shares documents with the Reforms Delivery Office (RDO), which is a higher strategic level unit advising the CoM. It is the understanding of the monitoring team that RDO helps ensure that the Strategy of the Reform of State Ownership, which was adopted in May 2015 by the CoM, will be implemented effectively. Reportedly the Strategy is being implemented through tightening of the budgetary oversight and monitoring of the fiscal risks; delineating functions of the CoM and of line ministries in view of their ownership and regulatory roles; increasing corporate transparency of the SOEs; balancing of interests of the management and the owners of SOEs; establishment of supervisory boards with independent directors in the SOEs, etc.

At the highest level and at the request from the PM and the President in April 2016 another advisory group was set up – the Strategic Advisory Reform Support Group (SAGSUR) – to steer the policy work in the area of state management, among other areas, at the highest level. This group includes prominent international and national experts and it reports directly to the PM and the President.

It appears that while multiple initiatives have been launched their actual achievements and results are still very few. It appears that a lot of work is being done but it does not yet find its reflection in legislation or policies of the state. Moreover, various bodies tasked with developing ways forward for reform are of advisory nature and operate on a short-term basis and at arm's length from the Ministries which they are advising. Their role should be strengthened and formalised by fully incorporating them into the structures of the Ministries.

4.2.5. Governance of the SOEs

Supervisory boards

In most OECD countries SOEs are incorporated as joint-stock companies or limited liability companies and they are subject to similar governance as enterprises operating in the private sector. Such an SOE has a board, called supervisory board or board of directors depending on the legislation, the members of which are appointed and removed by the shareholders at the general meeting of shareholders. The size and other characteristics of the board are regulated by the charter or the articles of association of the company. The members of the board are not usually employed by the company.

Supervisory boards, as they are called in Ukraine, have been introduced into SOEs fairly recently. The Law

on Joint Stock Companies defines the supervisory board as "... the agency that protects the rights of the company shareholders and, within the competence defined in the Charter and this Law, performs management of the Joint Stock Company as well as, controls and regulates the activities of the executive body." The establishment of a supervisory board is, however obligatory only in joint-stock companies with 10 or more shareholders. Consequently, still many SOEs incorporated as joint-stock companies but having only the State or just a few shareholders do not have supervisory boards.

Following the CoM Resolution 142 it has been made obligatory for SOEs with either (a) a value exceeding UAH 2 billion, (b) a net income exceeding UAH 1.5 billion, (c) a share capital above UAH 2 billion, or (d) the number of shareholders exceeding 10 to establish supervisory boards.¹¹ This applies to SOEs of all forms of incorporation, unitary enterprises as well as joint-stock companies.

The procedure for establishment of such supervisory boards is stipulated by the CoM. The governing entity of the SOE, which falls under the requirements for setting up a supervisory board, is required to (a) take this decision; (b) to initiate a general meeting of shareholders in order to bring the SOEs charter in line with this requirement and to approve the Regulation on Principles of Establishment of its Supervisory Board; and (c) after the general meeting of shareholders has been held, to launch a competition for the supervisory board candidates and to select independent members of the board to be finally appointed by another general meeting of shareholders. In addition, ownership entities have also been tasked to report quarterly to MEDT on the progress in the establishment of supervisory boards in their SOEs.

It appears, however that in many cases, if not all, the final say regarding appointments to SOE supervisory boards lies with the CoM.

The OECD Guidelines recommend that state-owner should establish a well-structured, merit-based and transparent board nomination process in fully- or majority-owned SOEs. The state should also actively participate in the nomination of all SOEs boards. The boards must be competent, independent and functional, which should enable them to effectively monitor the management and protect the management from interference in the day-to-day operations.

The regulation by the CoM provides for a competitive selection process and stipulates the qualifications of the independent members of the supervisory boards of SOEs. Supervisory boards of the SOEs should be composed of a majority of independent members, as well as representatives of the State which are appointed by the relevant State authority, and for the enterprises of particular importance – also approved by the Nomination Committee. The procedure for selection and nomination of the representatives of the State to the supervisory boards of SOEs has also been adopted.¹² It also stipulates their required qualifications as well as safeguards against existing or potential conflicts of interest.¹³

Contrary to the privately owned enterprises, currently the approval of the corporate strategy, of annual financial plans and of reports on execution of the financial plans, as well as of other decisions in regards to the economic activities of the SOE, does not fall within the exclusive competence of its supervisory board. CoM approves financial plans of SOEs which are natural monopolies and those SOEs the planned net profit of which exceeds UAH 50 million, in other cases it falls within competence of ownership entities.

¹¹ CoM Regulation #142 from 10 March, 2017.

¹² CoM Resolution #143, adopted on 10 March 2017.

¹³ Article 11-3 of the Law on Management of the State-owned property.

The supervisory board is not fully empowered to appoint and dismiss the CEO and decide on the CEO's remuneration according to generally accepted corporate norms.

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.

The supervisory board may appoint anyone of its members Chair. The CEO should give to the supervisory board full access to all necessary documents and data. The supervisory board prepares an annual report including an evaluation of its performance.

At the moment since the proper supervisory boards with independent members have been established only in a very few select enterprises, it is still to be seen how all these recently introduced changes will translate into practice. Furthermore, established supervisory boards seem to be often prevented from carrying out their functions in line with commonly accepted corporate norms and struggle to maintain their independence and CoM has retained in many cases the rights to nominate the CEO and to approve the corporate strategy, financial plans, etc.

CEO and Executive Board

In addition to a board of directors, in many OECD countries there often exists a corporate body called the executive board or the management board. This body is usually not regulated by the charter and it consists of the CEO, and a number of executive directors, employed by the company. The members of the executive board are appointed and removed by the board of directors. The CEO is the highest ranking executive officer who is responsible for the management of the operations of the enterprise and the implementation of its corporate strategy. The CEO is accountable to the board of directors.

According to the Law On Management of State-Owned Assets, the CoM approves the procedure for the competitive recruitment of CEOs for SOEs. The announcement of the competitive selection of a CEO 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 CEOs to strategically important enterprises¹⁴ was originally approved in 2015¹⁵. The selection of candidates for these CEO 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 CoM.¹⁶ Nomination Committee was comprised of 4 members (Minister of CoM, 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.

¹⁴ SOEs with (a) value exceeding UAH 2 billion, (b) net income exceeding UAH 1.5 billion, and (c) banks with state held interest of over 75 percent.

¹⁵ Order of the MEDT #157.

¹⁶ CoM resolution 190

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. Once duly empowered supervisory boards are established, also the selection process of the CEO should be fully transferred to them.

Implementation of these regulations and laws however presented numerous challenges in practice and is impeding many of the selected CEOs from taking up their duties, as they are awaiting a final approval of their appointment from the CoM or the MEDT. It is apparent that this procedure needs improvement and reportedly the Reform Support Team at the MEDT is currently working on the necessary amendments.

Fiduciary duty

The fiduciary duty of members of supervisory boards and of CEOs of SOEs is worded in a very ambiguous way in Ukrainian regulations. The Law on Joint-Stock Companies, as translated, stipulates, that "The supervisory council of a joint stock company shall be collegial body that protects the rights of the company shareholders and..." (Art. 51.1) and "Officers or bodies of a joint stock company must act in the interests of the company..." (Art.63.1).

The stipulations of the Law are sometimes clarified or reinforced by rules included in the statutes of a joint-stock company: "The supervisory board shall be a governing body responsible for the protection of the Company's shareholders' rights, and..." and "The supervisory board member shall act in the interests of the Company, and..." (Charter of NJSC Naftogaz, articles 60 and 62).

Unitary enterprises have no support in the legislation in this respect. For example the articles of association of NPC Ukrenergo include no reference to the fiduciary duty of either the supervisory board or the director of the enterprise.

Remuneration issues

The OECD Guidelines call for a clear remuneration policy for SOE boards which would foster the long- and medium-term interest of the enterprise and help attract and motivate qualified professionals. The Guidelines also state that the remuneration of the CEO should be decided by the board of directors and be linked to his/her performance.

Remuneration of supervisory board members is regulated by the CoM Resolution #668.¹⁷ The ceiling for the annual base salary of a supervisory board member is linked to the annual net profit of the SOE. The idea has been to make board positions attractive for good candidates and to bring them as close as possible to remuneration for such functions internationally.

The CoM Resolution #859 which regulated the remuneration of the executives of SOEs was amended in November 2015.¹⁸ These amendments allowed for the base salaries of the CEOs to become competitive and introduced a system of bonuses directly linked to the profits made by the enterprise. For example, the base salary is not anymore calculated on basis of the average number of employees of the SOE but is linked to the financial indicators of the company in the last financial year.

¹⁷ CoM Resolution #668 from 4 July 2017.

¹⁸ CoM Resolution #1034 from 11 November 2015.

The Template Contract for the CEO of an SOE has also been changed to reflect the salary and types of bonuses which the CEO is entitled to receive.

These reforms have aimed to bring remuneration of CEOs more comparable with private sector remuneration, with the overall objective of attracting qualified candidates and bringing more private sector experience into the management of SOEs.

Recommendation 5

1. 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.
2. 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.

4.2.6. Performance control

The performance of SOEs is controlled in a number of ways in Ukraine. Legal requirements are contained in the Law on Management of the State Property and other legislative acts, as well as in statutory documents and internal regulations of the enterprises. Performance control is conducted according to the criteria and procedures defined by the CoM and in line with methodologies developed by MEDT. In some cases ownership entities develop their own recommendations and templates for their SOEs in line with the requirements of CoM and following MEDT guidelines.

According to the law, on the company level performance control is exercised by the supervisory board in those SOEs where those have been established. The CEO reports to the supervisory board which then evaluates the performance. In many cases the CEO reports also to the general meeting of shareholders, even in companies with supervisory boards. The supervisory board reports to the relevant ownership entity on a regular basis about the performance of the company. In SOEs where supervisory boards have not been set up, the CEO reports directly to the ownership entity.

The governing entity collects this information, analyses it and takes necessary decisions to improve the efficiency of the SOEs. It provides appropriate feed-back to each SOE, as well as reports to the MEDT on the main performance indicators of its SOEs. This includes information on financial and economic performance of each SOE, its progress in implementation of the strategic development plans and the state of its corporate rights. This is done by filling out a standard form developed by MEDT.

MEDT then analyses the collected information with the view to evaluate the efficiency of the ownership entities. It provides feedback to the ownership entities, publishes its analysis in the annual report of its activities and submits the results of this unified monitoring to the CoM. MEDT's report to the CoM contains recommendations for necessary improvements in addition to the analysis.

Finally, CoM reviews the reported information and takes relevant policy decisions as well as decisions on necessary institutional and procedural changes. It can also make direct interventions concerning individual SOEs when appropriate, for instance by transferring their supervision from one ownership entity to

another.

In addition to these performance control measures stipulated by the Law on Management of State Property other control and inspection institutions of the State may conduct regular inspections and monitoring, as well as ad-hoc evaluations when requested by the CoM. For example, the Accounting Chamber of Ukraine, which is the Supreme Audit Institution (SAI) of Ukraine and reports to the Verkhovna Rada, reviews how effectively state institutions perform their various functions, including ownership function. In particular, in December 2017 it reviewed the efficiency of the management of the State assets as performed by MEDT and SPFU. Performance control over these ownership entities, as well as over SOEs supervised by them was covered in this report.

The Report of the Accounting Chamber in December 2017, concluded that a part of the SOEs fail to report on their performance to their ownership entity. Therefore, the ownership entities cannot fully evaluate the performance of their SOEs. The quality of this evaluation was also criticized by the Accounting Chamber report. It stated that in most cases performance evaluation appeared to be a formalistic exercise without proper economic and financial analysis and that no decisions to steer the enterprises followed such evaluations.¹⁹

The ownership entities also do not provide full information in regards to the performance of their SOEs to the MEDT. Information is not submitted concerning all SOEs and the quality of the submitted information is questionable. The formalistic information which they provide doesn't enable MEDT to conduct an in-depth analysis. The Accounting Chamber found that even based on the incomplete information MEDT concluded that in 2017 only 23 ownership entities of 85 have been effective in the supervision of their SOEs. Finally the reporting by MEDT to the CoM has, in the opinion of the Accounting Chamber been a mere formality. This reporting is not taken into account by the CoM when policy, strategic or management decisions regarding the SOEs governance are taken. The recommendations of MEDT have been left without addressing, including recommendations to improve the system of reporting and control.

This complicated formal system, which lacks any enforcement leverages, does not provide for efficient and effective performance control, and could be blamed, at least to some degree, for poor economic performance of SOEs in Ukraine.

Recommendation 6

Conduct proper performance control of SOEs by ensuring that:

- SOEs report timely and in full scope required by legislation on their performance to the ownership entities.
- Ownership entities perform proper economic and financial analysis and their decisions to steer the SOEs follow such evaluations.
- Ownership entities provide full information in regards to the performance of their SOEs to the MEDT enabling it to conduct an in-depth analysis.
- Results of performance evaluation are taken into account when policy, strategic or management decisions regarding the SOEs governance are taken.

¹⁹ From the conclusions of the Accounting Chamber report dated December 2017.

4.2.7. Financial control

Financial control over SOEs in Ukraine is conducted through internal audit of the enterprises and external audit performed on one hand by external auditors appointed by the enterprises themselves and on the other hand by several State authorities. Auditing and other financial monitoring requirements, procedures and actors involved in performing of these functions are defined and regulated by various laws, including the Law of Ukraine on Accounting and Financial Reporting, the Law On Audit, the Law on Management of State Owned Property, the Commercial Code of Ukraine, as well as by various CoM Resolutions and other regulations of MEDT and of regulatory and inspection authorities.

International Financial Reporting Standards (IFRS) are currently being applied to the accounting and the external audit of all active JSCs which are SOEs. Unitary enterprises are still in the process of transferring to IFRS and Ukrainian national accounting standards are currently being applied.

Internal audit

OECD Guidelines recommend that 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.

Since June 2016 SOEs, particularly unitary enterprises which are required to establish supervisory boards are also required to establish an internal audit function within their structure. Internal auditors should report directly to the audit committee of the supervisory board as well as to the supervisory board itself and have full access to all necessary documents within the SOE. Should an enterprise which has not set up a supervisory board have an internal audit function, this would report to the CEO, who in turn would report to the ownership entity.

It is apparent, that very few Ukrainian SOEs have established a functioning internal control function except for the very largest enterprises as well as those incorporated as joint-stock companies.

In practice, the quality of the internal audit function of individual SOEs is difficult to assess and could be done to some extent by the monitoring team only regarding the case-studied four SOEs. However, according to opinions shared by private professional auditors which conduct external audit of SOEs the accounting and audit methods used by the SOEs are outdated and very often fail to be effective.

Independent External audit

According to the OECD Guidelines the annual financial statements of SOEs should be subject to an independent external audit based on high-quality internationally recognised standards. Since June 2015 SOEs fulfilling certain criteria and being thus divided into two groups²⁰ have been required to undergo external audit. The procedure for the selection of the auditors and the appointment criteria for such auditors for Group I are defined by the CoM.²¹ In practice companies of the first group will use the services of the biggest, most reputable audit companies, most often one of the top auditing firms in Ukraine.

²⁰ Group I includes SOEs with value of assets exceeding UAH 2 billion, with net annual income exceeding UAH 1.4 billion; Group II includes SOEs with value of assets exceeding UAH 250 million.

²¹ CoM Resolution # 390 from 6 April, 2015.

In those SOEs which are since 2016 required setting up supervisory boards, it is within the purview of the supervisory board to select the external auditor, define conditions of his/her contract and his/her remuneration. This is noteworthy in the respect that in most OECD legislations external auditors are seen as "agents" of the shareholders auditing also the work of the supervisory board and thus being selected and appointed by and accountable to the general shareholders meeting.

The development explained above is very positive but it needs to be implemented in all SOEs which are obliged to do so. According to the MEDT data published in its 2016 Top-100 SOEs report, the implementation has been very poor. In particular, in 2016 out of 46 SOEs that belong to Group I only 19 had undergone external audit, others are still in the process of being audited or have not taken any steps towards this end at all. Implementation by the SOEs of the Group II is no better; in 2016 only 34 SOEs out of total 99 SOEs of this group have adhered to this requirement.

In addition to a lack of implementation, there are practical challenges which relate to the selection of external auditors and their ability to perform their functions. Private auditors met at the on-site visit shared the opinion that public procurement procedures for audit services are extremely bureaucratic and the application process itself requires so many resources that it discourages even major audit firms from participating in bidding processes for external audit of SOEs. Since the accounting and audit practices of the SOEs are outdated, working with them requires a lot of time and resources to produce an audit report. These factors have resulted in a situation where big audit firms are not interested in working with SOEs whereas smaller firms do not comply with the official requirements. It should be further noted that where independent external audit has occurred this has resulted in qualified reports in a large majority of cases, which points to a number of irregular practices in SOEs.

The State Audit Service

According to its Charter, established by the Decree no. 43 of the CoM dated 3 February, 2016, "The State Audit Service of Ukraine (the SAS) is a central executive authority, the activity of which is directed and coordinated by the Cabinet of Ministers of Ukraine and which forms and implements the state policy in the sphere of the public financial control."

At first sight it appears that the SAS has the same duties and powers as the Accounting Chamber, namely controlling the collection and the use of budgeted funds, with the exception that the SAS is accountable to the CoM and not to the Verkhovna Rada as the Accounting Chamber. The SAS does not have the status of Supreme Audit Institution (SAI) in contrast to the Accounting Chamber.

The role and functioning of the SAS met widespread criticism from several interlocutors, which the monitoring team met at the on-site visit including representatives of the Government, the SOEs, the law enforcement community, the private sector, the international community and the civil society.

The SAS has powers to verify and sign on all contracts and payments by public enterprises in the amount exceeding UAH 100 000 for goods and UAH 1 million for services. In big SOEs there is a multitude of such transactions made on almost a daily basis, which then makes SAS auditors practically embedded into the organisation and structures of these SOEs. Auditors of the SAS have reportedly permanent offices in the premises of such companies and are present in the day to day operation of the company.

The powers and functions of these auditors are very broad and this leads to serious implications both for the SOEs and their governing entities. The SAS performs state financial audit, revisions and monitoring of public procurement and conducts various inspections. It verifies adherence to accounting laws, accuracy of

financial reporting and efficiency of internal audit functions of the SOEs. It also has very broad sanctioning powers. It can require the CEOs of SOEs to address deficiencies that the auditors found and control that this will be done. The SAS can file motions against CEOs in courts on behalf of the State and directly apply administrative fines to SOEs. It can freeze the state budget support to the SOEs. It can require signed contracts to be annulled. It can refer its findings to the law enforcement bodies.

Such broad powers give SAS representatives a lot of leverage with the SOEs and ownership entities. This presents many potential opportunities for corrupt arrangements and has reportedly been used as a means for political meddling into the operations of SOEs. According to the law enforcement officials met by the monitoring team at the on-site visit, auditors of the SAS are often suspected of “blackmailing their SOEs” in one way or another. Private sector and civil society representatives and some of the Government officials agreed that these auditors are perceived as “number one scare of the SOEs management”.

MEDT Directorate of Internal Audit

It appears that the Internal Audit Directorate of MEDT can also perform regular or ad-hoc audits of the SOEs. In this case the audit is "internal" from the point of view of the Ministry but "external" from the point of view of the enterprises.

The role of the MEDT Directorate for Internal Audit is not quite clear to the monitoring team. Ukrainian authorities reported that this Directorate in 2015-2017 performed 27 audits on unitary enterprises (including 16 planned and 11 unscheduled) that resulted in detecting violations estimated at UAH 178 million in value, including losses estimated at UAH 66,6 million and in issuance of 123 recommendations on how to improve effective use of State funds and use of State property. It is not clear which unitary enterprises are being audited by this unit, and how this audit function correlates with the internal and external audit of the companies and that of the State Audit Service of Ukraine, as well as that of the Accounting Chamber of Ukraine.

The same audit directorates/units exist in all ownership entities and they too perform audits of their unitary enterprises.

This seems to be a resource heavy and costly system, which is inefficient and slows down or blocks the everyday operations of at least very large SOEs. It poses multiple corruption risks and potential for various abuses. Regardless of whether actual cases of corruption are wide spread and can be proven, this perception needs to be addressed and such broad powers should not be concentrated in one agency which has broad discretion on when and where to conduct its inspections.

In conclusion, there is still a large number of unitary enterprises with no proper internal and external audit i.e. no control. Financial control functions performed by the State appear to be a system with an excessively powerful body which duplicates some of the functions of the internal control of the SOEs themselves, functions of the ownership entities of financial performance control, functions of MEDT to verify financial performance. Obligation to audit externally the biggest SOEs has only recently been stipulated and results of its implementation are extremely poor.

Recommendation 7

Provide for effective financial control over SOEs by:

- Ensuring that internal audit function is established and functioning in SOEs.
- Ensuring that large SOEs are externally audited by highly qualified independent auditors in line with IFRS requirements.
- 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.
- Ensure that audit functions are not used for political or other improper interference in the operations of SOEs.

4.2.8. Transparency and disclosure

The OECD Guidelines recommend that SOEs should observe high standards of transparency and be subject to the same high quality accounting, disclosure, compliance and auditing standards as listed companies. In many countries the SOEs publish annual reports including both financial and non-financial information such as their governance, social responsibility and environmental impact.

In 2014 MEDT launched an initiative to prepare and publish quarterly and annual reviews covering the portfolio of the 100 biggest SOEs. This step was taken to improve transparency and accountability and continues to be implemented with the latest annual report being published in 2016 and the latest report covering the first 6 months of 2017 is also publicly available. Unfortunately this report has not been available in English since 2014.

Starting from February 2015 the state-owned companies are required to publish on a designated website a list of payments executed in the intervening year against each contract. This is a mandatory disclosure of the use of funds.²² This specific requirement hurts the competitiveness of SOEs compared to the private competitors.

In June 2016 the Law 1405 “On amendments to certain laws of Ukraine regarding management of state and municipal property objects” came into force introducing changes in regards to disclosure of information by the SOEs. This Law now 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, the annual reports of the supervisory board and the reports of the external auditors. In 2016 the Commercial Code of Ukraine (article 73) was also amended to oblige SOEs to disclose information on their activity. Disclosed information is to be published on their websites or on the official website of their ownership entity allowing free public access to such information. SOEs which are JSCs are required to disclose information on their activity in line with general requirements.

²² The Law "On Transparent Use of Public Funds" No. 183-VIII of 11 February 2015

SOEs are bound by the Law of Ukraine on Public Procurement which also requires publishing data and documents on all tenders (save some exceptions).

SOEs are also bound to disclose sector specific information as required by sectoral regulations.

CEOs of the SOEs are responsible for the disclosure and accuracy of the published information.

According to the report by MEDT by September 2016 MEDT and other line ministries had already published financial statements of around 500 SOEs.

The Law on Access to Public Information does not apply to SOEs as such, but it provides for access to certain information held by SOEs. For example, information about budget spending if the funding was received from the State; information about services if the SOE has been assigned special or exclusive rights, also information on the quality of produced foods and household goods, impact on the environment and other information that is of public interest.

Recommendation 8

1. 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.
2. Continue and improve the aggregate reporting by MEDT and consider translating that reporting into other languages.

4.3. Privatisation

4.3.1. Background and history

The monitoring team had during the on-site visit several opportunities to ask Ukrainian counterparts what should be done to remedy the numerous shortcomings of the Ukrainian State ownership. The reply was without exception or hesitation: privatisation. Abandonment of State ownership and moving of all assets into the private sector and ownership were seen as solutions to bureaucratic administration, non-professional management, archaic corporate governance, low efficiency and poor profitability, even corruption.

The OECD Guidelines do not include any recommendations in terms of privatisation and the OECD has not issued any recommendations or other legal instrument bearing on privatisation processes. Stocktaking on privatisation experiences and tentative conclusions on good practices has been issued.²³ These will be referred to in the following as the "OECD consensus". All steps of the privatisation process, including the decision to abandon State ownership, preparing companies for privatisation, selection of privatisation methods, decisions on timing and sequencing, steps to organise the process of privatisation, the role of

²³ Privatisation in the 21st Century: Summary of Recent Experiences, OECD Publishing, Paris, 2010 and OECD (2018) Privatisation and the Broadening of Ownership of SOEs and OECD (forthcoming).

external advisors and assessment and auditing of privatisation should be transparent, economically sound and competitive.

In Ukraine official privatisation started in 1992 when the first laws on privatisation were adopted and the first privatisation programme was launched the same year. Between 1992 and 1994 over 9000 SOEs were privatised as small enterprises and more than 2600 large SOEs were transferred to the private sector. This was in most cases done through non-competitive and ad-hoc processes. In 2000 the State Programme on Privatisation for 2000-2002 was adopted and launched privatisation in strategic industries, in the areas of natural monopolies, in heavy infrastructure and the sector of high technologies. In 2003-2004 the Kuchma regime sold hastily SOEs to various business groups with links to the Government, as well as transferred them into ownership of public officials through non-transparent methods. Most of these SOEs were then simply stripped of assets which led to the collapse of entire industries and a dramatic spike in unemployment.

In 2005 the Orange revolution put a stop to these practices but did not provide for any functional mechanisms to replace them. State programmes on privatisation have since then been adopted for 2005-2007, 2010-2012 and 2012-2014 but they have not resulted in effective privatisation.

The new Government, appointed in December 2014, briefly put privatisations of state-owned companies on hold in order to review and audit their operations. In 2015 MEDT together with the State Property Fund of Ukraine developed a catalogue of over 200 SOEs for potential privatisation which was approved by the CoM in May 2015. The Government also approved privatisation plans for 18 large companies, including energy generation and distribution companies, and a large fertilizers producer, the Odessa Portside Plant.

The privatisation of major assets was expected to start by the end of 2015. A pre-marketing campaign was conducted: short information memos ("teasers") of the largest assets were prepared and published. The State Property Fund together with MEDT developed mechanisms to retain and remunerate external advisors for the purposes of the privatisation process. However, in 2016 while Ukraine achieved solid growth, macroeconomic stabilization, and lower inflation rates, the pace of economic reforms decelerated, and one much-anticipated reform, the planned privatisation of state-owned enterprises, did not take place.

For example, the privatisation of the Odessa Portside Plant was not realised after two unsuccessful attempts to attract private investors.²⁴ The first attempt to sell the Odessa Plant in July 2016 failed amid warnings from international donors that the Government's handling of the sale was deterring credible Western bidders. The Government decreased the floor bidding price by more than half to around \$200 million in the second attempt to sell the Plant but still failed to draw any offers.

This fertilizer plant was meant to be the first big privatisation since 2014, and was to be followed by other operations. However, other planned sales of SOEs, including the thermal energy company Centrengo, have been postponed repeatedly, prompting investors to question the authorities' commitment to selling valuable but cash-strapped State assets and underlining the need to focus on better preparing of State companies for sale.²⁵

²⁴ Carnegie Endowment for International Peace, Ukraine Reform Monitor, April 2017 <http://carnegieendowment.org/2017/04/19/ukraine-reform-monitor-april-2017-pub-68700>

²⁵ Reuters, 7 December 2016 <http://www.reuters.com/article/us-ukraine-crisis-privatisation-idUSKBN13W1CH>

4.3.2. Privatisation programme, legal framework

Ukraine does not at present have a formal strategic policy document which could form a general privatisation programme, as was the case before when the last mid-term privatisation programme covered the period of 2015-2017. The ownership entities should present to SPFU the enterprises where, in their view, the State ownership should be relinquished. This should result under the present regulations into lists of enterprises to be privatized within set periods of time.

The Law on Privatization of State and Municipal Property (hereinafter Law on Privatization) was adopted on 18 January 2018 and it entered into force on 7 March 2018. This Law is a major improvement; it changes the conceptual approach to privatisation and essentially simplifies the regulation of privatisation of State and municipal assets. To implement the law the Order of SPFU #44726 and CoM decision #35827 have been adopted.

The number of assets, which are not to be privatised has been shortened, however the Law still contains a long list of such assets ranging from nuclear power plants to burial grounds. The objects for privatisation are divided into two groups on basis of the value of the assets, instead of six groups as under the previous legal regime. Assets valued at UAH 250 million or more and state holdings in Joint Stock Companies exceeding 50% are "large", and all others are "small".

It is noteworthy that privatisation may be initiated also by potential purchasers in addition to the privatisation authorities and the ownership entities. Sale and purchase agreements may now be governed by foreign law and disputes between the investors and the State may be taken to foreign arbitration. The Law covers now also the privatisation of municipally owned assets in addition to state-owned.

The Ukrainian authorities are also planning to reduce the number of state-owned enterprises by corporate restructurings, in the first place by merging enterprises with the intention of creating larger and financially stronger entities and vertically integrated industrial corporate structures.

Recommendation 9

Ensure rigorous implementation of the new Law on Privatisation.

4.3.3. Relevant authorities and their powers

The Cabinet of Ministers of Ukraine is the policy making body in the area of privatisation. CoM approves State programmes on privatisation, gives direction and oversees the implementation of these programmes by the State Property Fund of Ukraine. It makes decisions in regards to SOEs that cannot be privatised (a list of such SOEs is submitted by CoM for approval to the Parliament) and finally approves

²⁶ Order of SPFU #447 from 27 March 27 2018 “On approval of lists of small privatization objects subject to privatization in 2018”

²⁷ CoM decision #358 from 10 May 2018 “On approval of the list of objects of large privatization of state property subject to privatization in 2018”

the list of large SOEs for privatisation, liquidation or restructuring. Most of the procedures regulating privatisation are adopted by CoM or stipulated in the newly adopted Law on Privatisation.²⁸

In countries with active privatisation programmes, specialised privatisation agencies are often the main player involved in steering the privatisation process, and considered separate from a centralised ownership entity or coordination unit due in part to the sheer volume of transactions. The **State Property Fund of Ukraine** is the main authority responsible for the implementation of the privatisation policy. It has a broad set of functions, including the development of proposals on privatisation programmes, approval of the list of SOEs for "small" privatisations, pre-privatisation preparation of SOEs and their governance while they are undergoing the process. It also conducts the actual privatisation using the available appropriate methods. It implements its function through a central office, as well as regional offices in all oblasts of Ukraine. It also prepares draft regulation; for the implementation of the new Law on Privatisation SPFU developed 48 regulations and procedures.

MEDT and other ownership entities also play a role in regards to privatisation. Before the entry into force of the Law on Privatisation MEDT had proposed another approach to the reform of the SOEs sector through a procedure called "Triage", which was then approved by the CoM. According to this procedure all SOEs in ownership of the central government were divided into three categories of (a) SOEs which should remain in the long-term state ownership, (b) those that should be privatised and (c) and those that would be liquidated. In 2017 3444 SOEs had been divided into these categories and the lists had been made public on the website of MEDT. The monitoring team has been informed that this list is currently being revised based on the information that MEDT is receiving from ownership entities regarding the grouping of the SOEs into the three categories.

MEDT has also worked jointly with SPFU, the CoM Reforms Delivery Office and SAGSUR on development of the new Law on Privatization. It undertakes various initiatives in regards to State governance of SOEs, in which privatisation is also a big part.

MEDT and other ownership entities contribute to the privatisation process by providing their annual proposals on the SOEs which should be privatised. This should be done based on analysis of economic performance. Such proposals should contain forecasted revenues from privatisation, as well as analysis of implications which such privatization would have for the economy of the country. These proposals should be provided to the SPFU no later than every 1st October of the year. Once the decision on privatisation of an SOE has been taken, the relevant ownership entity is obliged to transfer the ownership rights of this SOE to the SPFU in line with the procedure adopted by the CoM.

The Parliament of Ukraine oversees the results, effectiveness and lawfulness of privatisation. For these purposes and for the analysis of the consequences of privatisation a Special Privatisation Control Commission is established. Members of this Commission are Members of the Parliament and they are appointed by the Parliament, which also adopts the Rules of Procedure of the Commission.

The new Law on Privatisation has streamlined and further clarified the roles and responsibilities of various State authorities in the process of privatisation. It also vested the responsible agencies with the necessary competencies to carry out their roles. It must be taken into account that the Law has been in force for only a few months but in practice it seems that there is still considerable room for improvement.

²⁸ Law on Privatisation of state and municipal property #2269-VIII, adopted on 18 January 2018.

Some agencies still overlap or duplicate each other. It is not clear how MEDT's "Triage" efforts correlate with SPFU's function to re-group and list SOEs for privatisation. Both agencies are requesting ownership entities to provide them with information in regards to SOEs that in the opinion of the entity should be privatised. It appears that such information is not always provided diligently. Various statements from SPFU officials pointed out that information received from ownership entities is often lacking in quality and is not complete. Under the new Law SPFU has reportedly requested this information in March 2018 and as of May it had received lists of SOEs proposed for privatisation from only 46 ownership entities.

It appears as well that the transfer of SOEs earmarked for privatisation from ownership entities into the administration by the SPFU is not functioning as expected. In 2015 23 out of 32 SOEs which were to be transferred to the SPFU had effectively been transferred. A new procedure for the transfer of ownership of SOEs intended for privatisation was adopted on 10 May 2018²⁹ and it foresees that such transfer should be completed within one month's time from the decision on privatisation.

The issue of resources is also of concern. In the first quarter of 2018 SPFU has been working on pre-privatisation preparations of 91 SOEs, 18 by the central office and 73 by SPFU regional offices. The number of SOEs up for large privatization in 2018 is 23. SPFU employs 460 persons in the headquarters and 1194 persons in its regional offices so by numbers the organization seems to be well stocked. The SPFU has a broad range of other functions and all in all 140 persons are working directly with pre-privatisation or privatisation issues. However according to reports of the Accounting Chamber of Ukraine SPFU's exercise of privatisation function is consistently underfunded. In 2016 less than half of the funding necessary for proper fulfilment of this function was allocated. The lack of sufficient and appropriate funding hampers apparently the efficiency of this relatively large organisation.

In conclusion, adoption of the new legislation on privatisation is clearly a positive step and Ukraine can be commended on it. The law clearly defines which bodies are authorised to make privatisation decisions and under which circumstances. However, if this law is not rigorously implemented it would undermine its credibility and commitment to see through privatisation in a transparent and accountable manner. Therefore, Ukraine is strongly encouraged to step up its efforts and ensure that its coordinating body, the CoM, rigorously controls implementation of various roles and functions by all bodies involved in the privatisation process. Ukraine has vested SPFU with broad functions and the primary responsibility for execution of privatisation. However it also needs to be properly funded and allowed to carry out the functions that are prescribed to it by law – including by ensuring the effective transfer of SOEs which have been earmarked for privatisation into the management of the Fund.

Recommendation 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.

4.3.4. Methods of privatization

The newly adopted Law on Privatisation has simplified the classification of SOEs which are put up for privatisation. They are now divided into two categories: SOEs with the value of assets exceeding UAH 250

²⁹ CoM Resolution #389 from 10 May 2018

million fall within the "large" privatisation category, all the rest fall within the "small" privatisation category. This is a significant improvement in comparison to the previously existing division into six categories, with more complicated criteria for the division.

The list of SOEs for large privatisation is put together by the SPFU, which submits it for final approval to the CoM. The list of SOEs for small privatisation is approved by the SPFU. Lists of SOEs up for privatisation at the municipal level are prepared and approved by the Councils of local self-governance. Lists of SOEs which have been included for privatisation for the upcoming year should be published on the SPFU website.

SOEs in Ukraine should, as a rule, be privatised through auction sales. Buy-outs or trade sales are exceptionally allowed in cases where an auction has not resulted in a sale. Five types of auction sales can be performed, (i) auction without conditions, (ii) auction with conditions, (iii) auction with step-by-step decrease of the initial price and with further submission of price bids, (iv) auction with decrease of the initial price, and (v) auction with review of submitted price bids.

The method of privatisation is chosen depending on which of the two categories the SOE under privatisation belongs.

"Small privatisations"

SOEs of the small privatisation category are sold exclusively through electronic auctions. The recently adopted Law requires the CoM to establish detailed regulation and to adopt several procedures including the procedure for conducting electronic auctions and for the selection of the electronic platform operator. It also authorizes electronic platforms, decides on the participation fee and procedure for its payment. CoM also approves the procedure for identifying the winner in an electronic auction, as well as the procedure to determine special conditions for auction sales.

An electronic auction takes place in accordance with the contract signed between the electronic platform operator and the organiser of the auction. SPFU approves a template contract for that purpose.

Once the decision on privatisation of an SOE through small privatisation is taken, an Auction Commission must be formed within 10 days of such decision. The Auction Commission is composed of at least 5 persons and it drafts the conditions for the sale of the SOE, which are then approved by the body conducting the privatisation. These conditions are then published within ten days of the approval and the sale can take place after 20 days, but no later than 35 days of publication. Protocols of the auction are electronically generated by the platform and published on the day when the auction was finalised.

"Large privatisations"

The CoM adopts several procedures and detailed regulations under which large privatisations are to be conducted. External advisers, which in the first place would include major, international investment banks, are given an important role in the preparation and privatisation of the SOEs which belong to this group. Such advisers are selected through a competitive process approved by the CoM and based on criteria of competence as identified in the Law on Privatisation. This selection should happen under maximal transparency and integrity.

The tasks of the advisers include the performing of an audit, an analysis of the economic, technical and financial performance of the enterprise, bringing indicators in the financial statements in line with

accounting standards, the preparation of a financing model, the determination of the attractiveness of the enterprise for investors and ways to improve it, setting of the initial price and the preparation of an information package on the SOE as well as identification of potential investors.

Advisers are firstly remunerated with a set fee, and if the SOE will be sold they also receive a success fee as a percentage from the sales price. Advisers are in the first place paid out of the State budget but the remuneration may also be borne by international organisations.

Should it happen that no qualified adviser would be available; the sales transactions of the SOE may be executed without advisors and by the relevant privatisation body performing the functions of the adviser.

An Auction Commission must be also formed for the sale of each SOE belonging to the large privatisation category within 10 days of the privatisation decision. The Auction Commission is composed of at least 5 persons and develops the conditions for the sale of the SOE, which are then approved by the CoM. Within 10 days the conditions for the auction sale are published and the sale can take place after 30 days, but no later than 60 days of publication. Protocols of the auction are electronically generated by the platform and published on the day when the auction was finalised.

Objects of large privatisation are subject to sale at auctions with conditions. Such conditions typically include an undertaking not to reduce the number of employees, maintenance of the existing product lines, technical re-equipment, payment of debts on taxes, salaries and wages etc. Fulfilment of such conditions will be costly for the buyer and they will thus be directly reflected in the purchase price. They may also prevent the new owner from re-organising the enterprise and from performing any managerial, technical and financial turn-around which would in many cases be necessary for the return of the efficiency and profitability of the enterprise. Imposing such conditions on the prospective buyer of any asset will considerably reduce its attractiveness.

Privatisation results prior to the adoption of the new legislation have been far from impressive despite the reforms. In 2015 out of 396 SOEs earmarked by CoM for privatisation 291 have been permitted to be privatised, 148 of these have been transferred to SPFU for management, as well as 14 SOEs transferred in 2016. SPFU has put 63 SOEs on sale and only 17 of them have actually been sold. In 2017 SPFU included 63 enterprises into the privatisation schedule, this list was further increased to 84 and 22 of them were sold that year. That same year 148 enterprises should have been transferred from the ministries to the SPFU, and only 36 have been actually transferred.

In May 2018 CoM approved the list of SOEs for large privatisation; a small privatisation list has also been approved. Starting from the second quarter of 2018 SPFU and other bodies involved in privatisation will start applying the new legislation. The results will be of extreme importance and an ultimate test of the new legislation.

It appears that new legislation provides for most privatisations to be done through a competitive bidding process. The time will show how these processes will be organised in practice. The results of the small privatisation, which is deemed “easy”, could be judged based on the revenues of these sales. And taking into account some recent negative experience in privatisation of large SOEs, perhaps it would make sense for Ukraine to consider sequential privatisation of such enterprises. Finally, it will be important for Ukraine to implement provisions on prevention of conflict of interest of all participants of the privatisation process, including members of the auction committees, advisors and persons responsible for privatisation within the privatisation bodies to ensure full integrity of the privatisation procedures. If any of these

persons or processes are compromised or even appear to be compromised – privatisation efforts of the government will be a failure in the eyes of the public and potential investors.

Recommendation 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.

4.3.5. Other measures to reduce the number of state-owned entities

As has been noted above, Ukrainian authorities regard privatisation as the principal means to reduce the number of SOEs in the country. In addition, the main policy is to extinguish totally State ownership in all privatisation transactions to the effect that the entire participation of the State, be it in a 100 % state-owned enterprise or a company with other shareholders, will be sold to other owners.

Privatisation however is a time consuming and costly exercise. Many Ukrainian SOEs are not profitable and as a consequence a major part of the economy is bleeding out the taxpayers' funds. The losses of the SOEs to be privatised must be borne by the state-owner during the time period needed for the privatisation process. A bulk of enterprises are for the moment typically not in such a shape as to attract serious buyers, willing to invest and to continue with the activity and the recent experience illustrates that international investors are very critical when looking at Ukrainian assets under State ownership. It was pointed out to the monitoring team that as a rule, the book values of the assets on the balance sheets of SOEs have not been reassessed and updated for some time since re-evaluation of fixed assets and inventories by certified evaluators is costly.

The SOEs being privatised should be equipped with a work force, administration, governance, accounting and capital structure which would make it possible to return into profitability under new owner- and leadership. Such "dressing of the bride" will have its cost. The excess number of employees should be reduced, which is politically uncomfortable. The process of large privatisations is expensive with the involvement of international investment banks as advisers and of auditors, legal experts, environmental audit etc.

In all cases of large privatisation the cost of the operation, including the losses produced by the enterprise under way, should be carefully assessed and reflected on the prospects of attracting acceptable buyers and on the realistically attainable sales price. An earlier SOE Reform Strategy called for all loss-making SOEs with non-strategic objectives, where a turnaround was not deemed feasible, to be liquidated without further restructuring. The "Triage" process by the MEDT has identified 1255 such companies. Liquidation of an enterprise may involve an element of privatisation if the production assets can be sold to new users. Decision on liquidation may also result in redundancy of numerous employees, which is a politically unattractive consequence.

In a number of countries governments have been successful in privatising stock-listed SOEs selling out first only a part of the state's participation, for example turning the former majority ownership into a minority or keeping the slice needed for minority shareholders' protection. Later then these governments have had the possibility to enjoy a higher value of the retained portion when the company has succeeded under increased private ownership. The securities market of Ukraine appears however to be unregulated, shallow and illiquid. There are two operative exchanges, the Ukrainian Exchange and PFTS Stock

Exchange, both of which have very limited turnover and capitalization. The Ukrainian privatisation authorities will have to seek access to foreign exchanges in cases where privatisation transactions involve selling state-owned stock to the public or are otherwise executed through the services of an official stock exchange.

During the early privatisation efforts Ukraine experimented with management buy-outs, however with discouraging results. In some cases the ownership of the enterprise was distributed to the entire personnel for free or against a nominal price. Such ill-fated operations led to the demise of the entity or to the ownership falling into unwanted hands since the new owners did not display interest. However, for small and middle-sized enterprises an MBO would be favourable from the point of view of the entity itself since competent management is aware of the existing problems and required remedies. The members of the management will be motivated as they will benefit from the gains in efficiency after privatisation. But a successful MBO necessitates the ability of the purchasers to pay a fair price for their shares. If an enterprise is sold at a heavily discounted price, there is no assurance that the management will be committed to running the company well.

Recommendation 12

Take measures to efficiently reduce the number of SOEs, including liquidations, mergers and other restructuring.

4.4. Anti-Corruption measures

This section of the report attempts to look into what Ukraine does to address endemic problem of corruption in SOEs sector and which anti-corruption tools are being applied, and most importantly how effective they are.

The OECD Guidelines define transparency and accountability among their standards and this directly serves anti-corruption purposes. Many of the anti-corruption provisions are applicable as well: i.e. regulation of conflict of interest, ethical rules, internal controls and compliance, reporting of corruption, etc. Corruption in SOEs is gaining more attention in recent years, and some international organisations are working on developing specific SOEs anti-corruption standards, including the OECD. Transparency International has already issued ten anti-corruption principles for SOEs in 2017; and a new set of OECD Anti-Corruption and Integrity Guidelines will be considered in 2019 and will serve as a guidepost for addressing corruption and other rule breaking specific to SOEs. The section below looks into tools and mechanisms, identified in these standards and which apply to SOEs.

4.4.1. Anti-Corruption policy

National policy documents

Ukraine's overarching anti-corruption policy documents include references and measures that relate to the SOEs sector. In particular, the Anti-Corruption Strategy for 2014-2017³⁰ identifies the operations of SOEs as a high risk area and includes it among those ten problems that the Strategy needs to address.

³⁰ While new strategic document has been drafted by the NACP, it has not been reviewed by the monitoring team, as its text may change and its further approval is pending.

According to the text of the Strategy anti-corruption requirements cover only officials of the legal entities of public law, leaving out a big number of employees of the SOEs. This leads to conflict of interest situations and non-competitive selection of staff, and often results in management of SOEs building private companies with the use of the SOEs resources. Public procurement in SOEs is done in a non-transparent manner. Decisions in regards to establishment, reorganization, objectives and results of SOEs are not transparent and the public has no access or understanding why SOEs exist and how efficient they are.

To address this, the Strategy provides a set of measures, including:

- 1) Amending the legislation to require the introduction of anti-corruption programs in SOEs, which would be based on risk assessment and would be approved by the National Agency on Prevention of corruption (NACP).
- 2) Establishing commissions headed by deputy directors/deputy CEOs of the SOEs and tasked with monitoring the implementation of the anti-corruption programs, providing advice on issues of anti-corruption and ethics, reviewing allegations of corruption and creating various anti-corruption mechanisms, e.g. channels for reporting of corruption, protection of whistleblowers, etc.
- 3) Amending the legislation to comply with the recommendations of the OECD Guidelines in regards to SOEs in Ukraine and extending the coverage of the Law on Prevention of Corruption to SOEs, to prevent conflict of interest, to introduce ethics codes, and to require declaration of assets.

The Anti-Corruption State Programme for 2015-2017 which was adopted to implement the above-mentioned Strategy reflects these measures. However, SOEs are directly covered by only one out of 27 main tasks of the Programme, and only four anti-corruption measures out of 85 are aimed at addressing corruption in SOEs. Arguably these measures can be of a different scope and are not necessarily comparable, however, addressing corruption gets lost in this document among the multiple other measures and no longer look as any sort of a priority area.

Other key policy documents which contain anti-corruption parts, for example the Work Programme of the Government of PM Groysman, adopted in April 2016 do not contain any measures directly addressing corruption in the SOEs sector at all.

This does not send a positive signal, as on one hand top level Government officials continue to acknowledge corruption in SOEs as one of the main problems in Ukraine and make political pronouncement that it should be tackled and on the other hand anti-corruption strategy documents do not treat it as a priority.

The main issue with anti-corruption policy documents of all levels rests with the implementation of the measures that they contain. These measures are individually covered throughout this section, as well as the previous parts of the report, but the general assessment is not positive. NACP reported limited progress in regards to at least the formal adoption of anti-corruption programs and the appointment of Anti-Corruption Commissioners to SOEs but their efficiency is questioned by this same agency. Most other measures seem to be still pending, not much has changed since the assessment was made by the civil society in March 2017.

Table 3 Implementation of AC measures in regards to SOEs – Alternative Report³¹

Anti-Corruption measure	Agency tasked with implementation	Timeline	Status of implementation
Task 16 – Corruption in SOEs			
Measure 1: A/C programmes and A/C Commissioners:			
a) Adoption of A/C programmes and appointment of A/C Commissioners in SOEs	Ownership entities	Before 1 April of each year	Not implemented on time
b) Methodological assistance on A/C programmes and A/C Commissioners to ownership entities and SOEs	NACP	Starting from December 2015	Not implemented on time
c) Inspection of ownership entities in regards to adoption and implementation of the A/C Programmes in SOEs	NACP in cooperation with ownership entities	2016-2017	Was not assessed
Measure 2: Implementation of OECD Guidelines in regards to Ukraine's SOEs			
a) Development of action plan to implement OECD Guidelines	MEDT and MoJ	July 2015	Not implemented
b) Adoption of this action plan	CoM	August 2015	Not implemented
c) Implementation of this action plan	MEDT and other relevant institutions	In accordance with the action plan	Not implemented
Measure 3: Amendment of the Law on Prevention of Corruption to cover SOEs on prevent conflict of interest and asset declarations			
a) Analysis of best practices and draft law and submittal of draft to CoM	October 2015	NACP and MoJ	Not implemented
b) Support of the draft law in the Parliament	February 2016	NACP and MoJ	Not implemented
Measure 4: Open registry of SOEs with information on beneficial ownership and results of the activities of SOEs	December 2015	SPFU	Not implement

Ukraine needs to ensure that addressing of corruption in SOEs finds its proper reflection in the new policy documents. Most importantly it should ensure that measures designed in the Anti-Corruption Strategy and the Anti-Corruption State Programme through 2017 have been implemented or transferred into the newly adopted documents.

Anti-Corruption Programmes of SOEs

According to the Law on Prevention of Corruption adoption of an anti-corruption programme is obligatory for State or municipal enterprises or business partnerships, where the State or municipal share exceeds 50 percent, the average number of employees for the fiscal year exceeds fifty and the gross revenue from the sale of goods or services during this period exceeds UAH 70 million. These criteria would cover a large number of the operating SOEs. Such anti-corruption programmes should be based on risk assessment, their

³¹ The information is directly taken from the Alternative report.

implementation should be monitored and assessed and they should be regularly updated. They should be approved by the CEOs of the SOEs. They should be easily available for the employees of the enterprises and be part of the rules of conduct as well as the contracts signed with the employees. It would be advisable to also include anti-corruption clauses into all contracts of each SOE and to publish the anti-corruption programme on the website of the SOE for potential partners and the public to see.

Ownership entities are tasked with ensuring that the SOEs under their supervision comply with this requirement. NACP controls the adoption of these programmes; however its role is limited to merely checking the existence of such programmes. NACP also has tasks in an advisory and guidance capacity. It has developed methodological guidelines on risk assessment and on development of such programmes as well as their implementation.³² A template Anti-Corruption Programme for legal entities has been approved by NACP³³ and it contains the minimum of the required elements.

The monitoring team does not have information on how many such anti-corruption programmes have been adopted. In 2016, when this legal requirement had been in force for two years, Transparency International of Ukraine conducted an assessment of corporate transparency in 50 top SOEs in Ukraine and found that only 20 of these companies had anti-corruption programmes available on-line. It concluded as well that most of these programmes followed the same format and contained almost identical provisions, regardless of the sector of the companies' operation, their size, types of potential risks, etc. The monitoring team had the same impression from looking at several such anti-corruption programmes: they are simple carbon copies of the template provided by NACP.

NACP also confirmed that anti-corruption programmes have not been introduced in all SOEs by the ownership entities that NACP had inspected so far. In its 2016 report NACP identified deficiencies in the work of most inspected ownership entities in regards to the development of such programmes. Representatives of NACP met at the on-site visit shared that although they had not looked into many of the SOEs anti-corruption programmes, the reviewed ones for the most part were not based on risk assessment. In fact only two SOEs, Energoatom and Metropoliten, requested NACP's advice and assistance in regards to the development of an anti-corruption programme and the conduct of risk-assessment. Energoatom is identified in the Transparency International-Ukraine assessment as having the best anti-corruption programme.

In conclusion, it appears that even when anti-corruption programmes are mandatory, they are not always introduced. Risk assessment is not used consistently, if at all, throughout the SOEs and the guidance and follow up by NACP are limited. NACP's role is limited to checking that such programmes are in place and it does not have the mandate to assess their quality or implementation. Ukraine should ensure that anti-corruption programmes are introduced in all SOEs which fulfil the set criteria and that this will be more than a mere box-ticking exercise. Anti-corruption programmes should be developed properly to serve their purpose of addressing and preventing corruption in companies that adopt them.

³² Adopted by NACP Decision #734 from 22 September 2017.

³³ Adopted by NACP Decision #75 from 2 March 2017.

Recommendation 13

1. 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.
2. 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.

4.4.2. Specialised anti-corruption institutions and units

NACP plays a policy and prevention role in the context of addressing corruption in the SOEs sector. It develops guidelines and controls that the Law on Prevention of Corruption is properly implemented, including the introduction of anti-corruption programmes, the appointment and dismissal of Anti-Corruption Commissioners, the prevention and elimination of conflicts of interest, the collection and verification of asset declarations, etc.³⁴. It coordinates and provides advisory support in the identification of corruption risks in the ownership entities and in the SOEs as well as their elimination.

NACP reports to the CoM and the Parliament on the progress made in the area of anti-corruption by the SOEs, along with State authorities and bodies of self-governance. It can develop recommendations for ministries and other State agencies which are ownership entities in regards to anti-corruption work with SOEs. It can issue orders to the heads of ownership entities and CEOs of SOEs when rules on ethics, conflicts of interest or financial control included in the Law on Prevention of Corruption have been violated. These orders require heads of ownership entities or CEOs to eliminate the violation, to conduct internal investigation or to apply appropriate sanctions to the person who violated the law and to report back to *NACP*. *NACP* can also initiate administrative sanctions directly through court.

NABU and *SAPO* are specialised law enforcement bodies which have legal powers to investigate and prosecute corruption in SOEs when it's conducted on a large scale. Other law enforcement bodies investigate and prosecute corruption of the smaller nature.

Anti-Corruption Sectors and Commissioners in the ownership entities are responsible for ensuring that their SOEs are aware of the anti-corruption requirements which apply to them and that they comply with such requirements. They sign anti-corruption programmes, liaise between *NACP* and their SOEs and report to *NACP* on measures undertaken by their SOEs to implement anti-corruption requirements. Ownership entities are involved in the process of appointment of the Anti-Corruption Commissioners in their SOEs and these Commissioners can directly appeal to the heads of the Anti-corruption Sectors and Anti-Corruption Commissioners of the ownership entities, this applies to unitary enterprises only. Anti-corruption units of the ownership entities also provide anti-corruption training for SOEs Commissioners and other employees.

Anti-Corruption Commissioners have to be appointed in those SOEs which are obliged to adopt anti-corruption programmes.³⁵ Anti-Corruption Commissioners are appointed by the CEOs or the supervisory boards of the SOEs and they can be dismissed only upon consent from *NACP*. Their primary responsibility

³⁴ In regards to persons covered by Article 3 of the Law on Prevention of Corruption.

³⁵ Law on Prevention of Corruption, Article 62

is the implementation of the anti-corruption programmes. Procedures identifying the scope of powers and functions of Anti-Corruption Commissioners and their subordinates are usually contained in the anti-corruption programmes, along with a mechanism of regular reporting of the Commissioner to the management. Other anti-corruption units have been created according to the CoM Resolution in 2013, including in some of the SOEs. It is not clear how these units coordinate with newly created Anti-Corruption Commissioners. This issue should be addressed to ensure that multiple or duplicating units/persons do not exist.

Functions of Anti-Corruption Commissioners should normally include:

- Monitoring and control over the implementation of the Anti-Corruption programme;
- Collection and follow up on the reports of corruption from the employees of the SOE;
- Conduct of internal investigations and disciplining of employees who have breached provisions of the anti-corruption programme;
- Collection of information and addressing of any conflict of interest;
- Consulting the employees on issues of anti-corruption and ethics;
- Organising anti-corruption training;
- Reporting anti-corruption violations to the Anti-Corruption Commissioner of the relevant ownership entity, the CEO and NACP.³⁶

The situation regarding the appointment of Anti-Corruption Commissioners is similar to that of anti-corruption programmes. Again, the actual figures on how many SOEs have appointed such officers are not available to the monitoring team and do not seem to have been assessed by Ukrainian authorities. The report by Transparency International-Ukraine on corporate transparency stated that information in regards to the existence of such officers was scarcely published by the SOEs. Representatives of ownership entities met by the monitoring team in 2017 informed that some of their SOEs have already done so. NACP also shared that Anti-Corruption Commissioners now exist in a number of SOEs.

However, NACP found that in most cases this role was assigned to an existing employee, and often in addition to his/her previous or other tasks which inevitably influences the quality of his/her anti-corruption work. One of the SOEs met at the on-site visit shared that they had to make efforts to convince their ownership entity to allow them to hold an open competition for the Commissioner's position. The Transparency International report quotes the examples of Naftogaz and Ukrzaliznytsia as SOEs which held open competitions and established real units of compliance. To address these issues NACP has issued a separate letter advising the ownership entities and SOEs that such officers should be separately appointed and contracted.

NACP can check the performance of anti-corruption units created under the CoM resolution, it does not have the same powers towards Anti-Corruption Commissioners. This has not been done yet in regards to SOEs and therefore it is not possible to make any meaningful conclusions. However, taking into account the quality of the anti-corruption programmes, it may be inferred that for the moment the Commissioners are not performing at an efficient level.

In order to raise the levels of qualification of Anti-Corruption Commissioners they should be properly trained. This has not been done in any centralised way for SOEs, like it is being done for the

³⁶ Reporting to the CEO and Supervisory board does not seem to be a requirement, and if that is the case – it should be included into the list of functions.

Commissioners of the ownership entities. Perhaps it would make sense to include SOEs Commissioners in the next trainings organised by NACP.

In conclusion, while the formal requirement to appoint Anti-Corruption Commissioners in several SOEs has been introduced – it is not yet been implemented in all concerned SOEs. Moreover, it appears that the persons are being appointed to these positions without any competition which should ensure the necessary qualifications. They also seem to be often performing other duties and approach their anti-corruption duties formalistically.

Ukraine needs to ensure that Anti-Corruption Commissioners at the SOEs are in fact competent and qualified to carry out their duties, as well as well-equipped and resourced for performance of their broad functions, and that their status and mission are well communicated to all employees and supported by the management of the SOEs. They should be able to act independently but also be accountable to the Supervisory Board and its audit committee, in addition to the CEO, where supervisory boards exist and in relevant cases to NACP and the Anti-Corruption Commissioners of their ownership entities. And finally, they should be appointed through open competitions and their qualification should be raised on a regular basis.

Recommendation 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.

4.4.3. Prevention measures

Scope of application of the anti-corruption legislation

The Law on Prevention of Corruption identifies the persons covered by this law in its Article 3. However, in regards to SOEs some difficulties have arisen. There seem to be two problems with defining the persons covered by this law when it comes to SOEs. Article 3, part 2 (a) defines persons which are equivalent to those carrying out state functions and includes “officials of legal entities of the public law”, it also includes members of the supervisory boards of SOEs.³⁷ The first problem is in defining which SOEs are to be covered by the definition of “legal entities of the public law”. The second problem is in who is covered under the term “officials of the legal entities”.

“Legal entity of the public law”

According to Article 81 of the Civil Code a legal entity of the public law is a legal entity which was established by an act of the President, of a State body or a body of the local self-governance. At the same time Article 167 of the Civil Code states that the State can also create legal entities of the private law. To

³⁷ In addition, Article 3 covers “persons which permanently or temporarily hold positions connected to organisational and management, or administrative and economic functions, or those that have been specially appointed to carry out such functions in legal entities of private law regardless of their organisational and legal form, as well as other persons which are not officials and carry out the work or provide services in line with the contract signed with the legal entity”. A more limited number of provisions of the Law apply to this second group, they, for example, do not submit asset declarations and are not covered by the conflict of interest provisions, and therefore, are not discussed in this section.

create any legal person the State body must issue an act (Article 81 of the Civil Code). This would qualify all enterprises created by law as legal entities of the public law. How the legal entities of private law can be created and how they are different from the legal entities of public law is therefore unclear. However, they appear to exist and the charters of many enterprises which have been established by various State bodies contain provisions identifying them as legal entities of the private law, and these statutes have been adopted by the CoM or other ownership entities.

“Officials of the legal entity”

This issue has caused a lot of controversy and debates at various policy and enforcement levels. The Commercial Code of Ukraine³⁸ has identified the CEO, the chief accountant and the members of the supervisory board as persons which are officials. Charters of SOEs also often define the officials, but not necessarily in the same manner. NACP has issued a blanket explanatory note in this regard, which is of advisory nature as it has not been confirmed by the Ministry of Justice.

According to the NACP explanatory note officials of legal entities covered by the anti-corruption legislation are employees of legal persons of the public law which have official powers to carry out organisational and managerial or administrative and economic functions. However, for example, acting CEOs are not included into this list according to the explanation. This is not logical taking into consideration the scope of their powers and the management decisions that they take in Ukraine where many SOEs for the time being operate under the management of an acting CEO.³⁹

The issue of which legal entities and which persons within these entities are covered by the provisions of the Law on Prevention of Corruption should be clarified in law as a matter of priority. Legal uncertainty on this matter is unacceptable. It is already leading to serious consequences, such as potential liability for those SOEs and their staff who have not submitted declarations following guidance from their management or ownership entities. NACP will be burdened with a large number of declarations from persons who have no management or decision making functions and are in a low level of corruption risk but have submitted declarations following the decision of the management for all staff to submit. Finally, the free pass on anti-corruption measures for acting CEOs needs to be eliminated to reduce the risk for conflicts of interest and corruption.

Asset declarations

Persons listed in Article 3 part 2 (a) of the Law on Prevention of Corruption are required to submit annual declarations of assets in their ownership. Candidates for such positions are also required to submit declarations. Administrative and criminal liability can be imposed in case of violation of this requirement.

The requirement to declare assets by the management and other personnel of the SOEs has been a challenge in actual practice. Due to the unclear of 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

³⁸ Article 65 of the Commercial Code

³⁹ Among other reasons – this is due to delays and failures of selection and appointment of CEOs in the recent years, as described in this report.

have been submitted by the managers or employees of these SOEs. All SOEs met at the on-site visit told the monitoring team that they have requested NACP for a clarification on who should declare. Responses to these individual queries contained advice to refer to the blanket explanation, which did not answer their questions in full.

The requirement for supervisory board members to disclose their assets, as well as for candidates for these positions, which was introduced through amendments in March 2017, is another problem. This requirement applies to both Ukrainian and foreign nationals. It has caused much controversy and is argued to deter good candidates from outside of Ukraine from applying. There are several technical issues which go along with this requirement, for example the necessity of obtaining an electronic signature key, which is needed for the submittal of declarations. Applying for such a key requires in its turn submitting various documents that are Ukraine-specific and do not exist outside of Ukraine. Present supervisory board members, especially foreigners, are concerned with this requirement, and in some cases they have threatened to resign.

Asset declarations of the management of SOEs and supervisory board members is a good measure from the anti-corruption point of view at the same time representatives of some SOEs find it discriminatory and such that put them in disadvantage in comparison to other companies and create risks of political meddling. However, it needs to be applied first of all consistently to all SOEs. Clear guidelines should be developed as to which persons within the SOEs should report. If such requirements are also to cover foreign nationals, technical issues to enable such submissions should be resolved before such a requirement is enforced triggering any sort of a liability. Ukraine needs to address this issue urgently to avoid further misinterpretations and violations of the law.

Conflict of interest

Both potential and actual conflicts of interest are clearly defined in the Law on Prevention of Corruption.⁴⁰ Officials and other personnel of any SOE, as well as persons that work for the SOE under contract agreements, must immediately report situations of potential and actual conflict of interest to the Anti-Corruption Commissioner of the SOE and its CEO.⁴¹ The procedure for reporting, as well as for resolving of the conflicts of interest should be included in the Anti-Corruption Programme of the SOE.

NACP is responsible for monitoring and control over the implementation of these provisions in the SOEs which are covered by this Law. It is also tasked with providing explanations as well as methodological and advisory support on issues of ethics and prevention and elimination of conflicts of interest in regards to SOEs and their relevant staff. NACP can also take measures when situations of conflict of interest or breach of ethics take place by issuing orders to heads of ownership entities or CEOs of the concerned SOEs requiring them to eliminate such situations or breaches and punish the responsible persons.

There was little information on enforcement of the regulations on conflicts of interest in SOEs available to the monitoring team. Some SOEs met at the on-site visit informed that they had instances of conflicts of interest and that they managed to successfully resolve them. NACP also has issued 159 administrative protocols in regards to violations of conflict of interest rules in 2017. 17 of these concerned officials of SOEs. It is difficult to assess if this is a big number as it is not clear how many SOEs have been checked, as compared to other state institutions. Most of these violations have been failures to report a potential or

⁴⁰ Article 1 of the Law on Prevention of Corruption.

⁴¹ Article 61 of the Law on Prevention of Corruption.

actual conflict of interest, as well as taking decisions in situations of actual conflict of interest.

On the other hand – NACP in its 2017 activity report listed conflict of interest in SOEs as one of the most common violations of the anti-corruption legislation and stated that SOEs and their ownership entities need to step up their efforts in this area. It also noticed that hiring and directly subordinating closely related persons was common place in SOEs. SOEs officials apparently believed that since the limitation to employ closely related persons did not apply to legal entities they could do so, without realising that such actions constituted actual conflicts of interest.

It appears that more needs to be done in order to clarify to the SOEs management, Anti-Corruption Commissioners and employees which situations would represent potential or actual conflict of interest. It is also necessary to step up the enforcement and, as practice develops, analyse it and identify necessary improvements to reduce situations of conflict of interest in SOEs to the minimum.

Ethics codes and rules of conduct

Anti-Corruption legislation encourages SOEs which are obliged to develop and adopt anti-corruption programmes to also introduce codes of ethics or other ethical rules. This however seems to be done very superficially. The monitoring team has seen several examples of very general codes of ethics. Recommendations to ethical behaviour are often made in the rules of conduct for the SOEs employees and are even more diluted. According to the Transparency International corporate transparency assessment in 2016 only four of the 50 reviewed SOEs had adopted codes of ethics that could be found on their website. Whether and how they are made available to the companies' employees is also questionable. And finally the move from mere declaration of ethical standards and actual enforcement of such standards needs to be made.

Reporting of corruption and whistleblower protection

According to the law channels for reporting about corruption should be established in all SOEs which are under the obligation to establish an anti-corruption programme. Some of these SOEs reported that such channels have been established ranging from anonymous reports which can be submitted on-line, to hot-lines, reception days with the management etc. These can all be effective if they are really used by the employees and other outside parties. Some SOEs have shared that they receive many complaints, many of which do not deal with corruption but with other issues and others have stated that no corruption-related reports have been received.

There is no information on cases of whistleblowing in the sector in the public domain. NACP which works with whistleblowers could not recall any whistleblowers directed to them for protection and cooperation by the SOEs. This in contrast with levels of detected and perceived corruption in the sector creates impression that reporting channels are not functioning as they should yet.

The Anti-Corruption Commissioners should play a key role in ensuring that reporting channels function properly. These tools should not only be made available but also be promoted to the employees by the SOEs. The employees should be encouraged to report instances of corruption and they should be also clearly explained that non-reporting of corruption results in liability. Of course, they should be convinced that they can report without fear of reprisal. It doesn't appear that all of these elements are currently in place and properly function.

The Law on Prevention of Corruption provides for whistle-blower protection. The Anti-Corruption

programmes of SOEs are also expected to contain such clauses. However, the real practical availability of such measures should be ensured by the SOEs, but it does not appear to be a common practice at the moment.

Anti-Corruption training

Anti-corruption training is to be integrated into the anti-corruption programmes of the SOEs and should be organised by the Anti-Corruption Commissioners. Representatives of the SOEs whom the monitoring team met at the on-site visit stated that they regularly conduct training for their staff but complained that the role of NACP in this has been very passive. On the other hand NACP has shared that all subjects of the Law on Prevention of Corruption, including SOEs can request for their assistance, also regarding training, and they can also take part in regular trainings organised by the NACP. NACP believed that when ownership entities find it relevant they will invite SOEs representatives to take part in anti-corruption trainings organised by the NACP. NACP ensured the monitoring team that they plan to take some of these actions in the nearest future.

It appears that the lines of communication and coordination in regards to anti-corruption trainings organised by NACP can be improved. In addition, NACP should be encouraged to proactively include the Anti-Corruption Commissioners of the SOEs in their future trainings. Anti-corruption trainings within the SOEs organised by the Commissioners should become regular and have a practical nature.

Procurement⁴²

Public procurement has been identified as one of the main problems in the context of corruption in the SOEs sector. State policy documents, governmental statements, law enforcement reports and statistics – all confirm the same.

Procurement by the SOEs is an impressively large area of State expenditure. In 2016, for example, the overall amount of procurement needs estimated by SOEs in Ukraine was UAH 410.5 billion according to the State Statistics agency. This was about 75% of all public procurement.

The goals of the State Anti-Corruption Programme for 2015-2017 included those aimed at a reform of the overall procurement system, as well as those aimed at reducing potential for corruption when procurement is conducted in practice by the SOEs.⁴³ However, no specific measures to achieve these goals in regards to procurement in SOEs can be found, perhaps the general procurement reform was meant to do so.

In December 2015 the Public Procurement Law made the use of the Prozorro system mandatory for purchases above a certain threshold amount by government entities, including SOEs. The connection to the system was implemented in two stages: central executive bodies and large SOEs were integrated starting 1 April 2016, while all remaining public procurement entities started 1 August 2016. The lower ceiling for the use of the e-procurement and the rules of the non-electronic purchase are however defined by the SOEs themselves. Such decisions do not have a legal nature and are not registered with the Ministry of Justice

⁴² Additional information in regards to the general rules and procedures for the public procurement can be found under Section 2.5 of this report and they are applicable to the SOEs. More information in regards to violations in this area can be also found in the section on enforcement and results.

⁴³ Goal 6 in the Part II of the State Anti-Corruption Programme.

like similar orders of, for example ownership entities, would be registered. Thus they do not undergo anti-corruption technical expertise to establish whether corruption risks have been taken into account when rules were designed.

Procurement by SOEs appears still to be open for abuse by management of various levels, including middle management, since many procurement decisions are de-centralised. Despite the recent changes in the procurement system, which have been described in the section 2.5 of the main report, public procurement in Ukraine continues to carry high risks of corruption.

In its activity report for the first half of 2017, NABU identified corruption in the SOEs sector as one of the main priorities for its work. The analysis of cases involving SOEs single out corruption in public procurement as the number one crime type for this sector. To name a few of such cases: NABU's high-profile case linked to SOE "Ukrzaliznitsya"; the cases linked to the Administration of Sea Ports, including SOE "Pivdenniy"; the case linked to SOE "Energoatom" – all these examples represent recent cases of corruption in public procurement by SOEs.

In conclusion, the issue of corruption in public procurement of the SOEs should be given a separate consideration. Procurement practices, recorded abuses and relevant criminal corruption cases should be analysed in order to design specific tools for SOEs to reduce corruption and to eliminate existing loopholes which allow for corrupt behavior in this area. These tools should be then vigorously applied.

There are many other issues which relate to prevention of corruption, including transparency and disclosure of information, internal and external audit, open competitions for the selection and appointment of board members and CEOs, etc. These have been covered in other sections. There are also issues which have an impact on the prevention of corruption and were not covered in this brief report. However, the importance of prevention cannot be overstated and Ukraine needs to put all of the tools made recently available in the law into practice.

Recommendation 15

1. 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.
2. 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.
3. Ensure practical availability of whistleblower protection measures within the SOEs.
4. 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.
5. 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 behavior in this area.

4.4.4. Enforcement and results

General overview of cases

Corruption cases involving SOEs and their officials comprise a quarter of the on-going cases of the specialised anti-corruption agencies which deal with top level corruption – NABU and SAPO. By the end of June 2018 out of 793 criminal proceedings of NABU over 194 dealt with SOEs and their officials. Almost 50 SOEs are currently being investigated and most of them belong to the top 100 SOEs, as identified by MEDT in 2016.⁴⁴

NABU has made an in-depth analysis of these cases and provided an especially comprehensive overview of cases related with SOEs in its report for the first half of 2017. As of end of June 2017 - 32 cases out of total 78 have been already filed with courts.

Based on NABU's analysis the most corrupt SOEs appear to be in the energy and oil sector (40%), military and defence (27%), chemical industry (13%), infrastructure sector (8%) and agriculture (2%). Most of these cases involve the top management of these SOEs, as well as officials from ownership entities, regulatory bodies and other authorities responsible for the oversight of the concerned SOEs. According to information received from NABU reports these cases involve large damages to the State, estimated at UAH 20 billion by the middle of 2017. The highest damages are estimated in the case involving SOE Ukrkazvidobuvannya (UAH 740 066 million); followed by Zaporizhzhya Titanium and Magnesium Plant, Odessa Sea-side Port, State Food and Grain Corporation of Ukraine, and SOE "Nazproekt Povitryanni Express".

NABU analysts and detectives have identified five most common types of SOEs-related crimes:

- Purchase of goods, works and services at artificially inflated prices;
- Artificial limiting of competition;
- Sales of the products of SOEs at artificially reduced prices to intermediary companies;
- Signing of contracts with fictitious companies; and
- Payments for goods, works and services that have never been provided.

Sector-related corruption

The sectors where corruption is most common are of key importance for Ukraine's economy. SOEs in these sectors often represent monopolies, very often they are among the biggest employers and tax-payers in the country. Control over these SOEs provides for unprecedented opportunities for enrichment, as well as political influence. Subsequently, various political groups are at constant fight with each other in regards to influence over these sectors and enterprises.

This is especially true in the oil, gas and energy sector, where corruption appears to be most prevailing. Corruption has been detected in many of the leading SOEs of this sector, and according to the information received from NABU the cases involve Naftogaz, Energoatom, Ukrnafta, Ukrkazvydobuvannya, and Centerenergo.

⁴⁴ Information is taken from the NABU activity reports for the 1st and 2nd part of 2017.

SOEs in the oil extraction industry are often made to sell raw materials to certain predetermined companies, which never pay their bills. Ukrnafta is one such example – investigation of corruption allegations is currently on-going. Such allegations include illegal take-over of oil and monetary funds in 2015 in an amount exceeding UAH 7 billion. By the estimations of NABU by mid-2017 damages to SOEs in oil and gas extraction account to UAH 8 billion in total with approximately UAH 1 billion in seized and confiscated assets. Currently the investigations are continuing concerning 29 suspects. 12 indictments have been filed with courts against 18 persons and seven persons have already been found guilty by courts.

SOEs producing electricity are also undermined by corruption: the money paid for the use of the energy is not transferred to the provider of this energy but onto bank accounts of private intermediaries. NABU detectives have uncovered this scheme and are now engaged in court proceedings demanding that contracts with such intermediaries be declared void (amount of transaction exceeds UAH 950 million and the claim rights returning to the ZaporyzhyaOblenergo and CherkassyOblenergo) and money returned to the providers of electricity. ZaporyzhyaOblenergo has received UAH 40 million returned already. The amount of contracts that NABU is demanding to be annulled totals almost UAH 1 billion. Currently 16 indictments have been filed with courts against 22 persons and 10 persons have been found guilty by courts.

Nuclear energy SOEs have been allegedly involved in massive procurement abuses. For example, there is an on-going investigation concerning Energoatom and alleged abuses where various goods have been procured. Purchases included anything from computer software to concentrate of uranium. Currently the investigations are on-going in regards to 19 suspects, four indictments have been filed with courts and three persons have been found guilty. In these cases the total amount of assets that have been seized or confiscated is approximately UAH 100 million.

In other sectors other forms of corruption are more commonly used. For example, according to the NABU reports the sector of infrastructure and transport is dominated by cases where works and services are purchased at artificially inflated prices. This is usually done through collusion between various private companies and the management of the SOEs procuring the goods. In this way fair competition is impeded either to help companies affiliated with the management to obtain the contracts or to directly pay kick-backs to the management.

Most common cases in the agricultural sector involve the use of intermediary firms which purchase products of SOEs at artificially reduced prices and then resell them at competitive market prices. The difference is kept by the intermediary firms which are very often affiliated to the management of the SOEs.

Other schemes would involve fake purchasing of equipment for maintenance of factories. Special equipment is excluded from the inventories of SOEs and thus can be bought multiple times when need arises. This most commonly happens in the military and defence sector.

In conclusion, most of these schemes have been in place for years and in fact the management of these SOEs does not even bother to monitor market prices or provide a well-argued comparative analysis of prices when making purchasing or sales decisions. Most large SOEs have “satellite companies” which will win all tenders and do the business with the SOEs. It appears however, that these schemes are well known, often tolerated and rarely given a closer look. This needs to be changed if fighting corruption in SOEs is to be taken seriously.

High profile cases

It comes as no surprise that when NABU and SAPO report on their main operations and developments

SOEs-related corruption cases are prominently featured in these updates.

Table 4 – NABU’s key development which relate to SOEs’ related cases in 2017

Month	Key developments related to the corruption in SOEs
January	6 persons have been arrested as suspects on taking over the harvest at estimated value of UAH 50 million from the SOEs in Kyrovograd oblast.
February	Former CEO of SOE “State Food and Grain Corporation of Ukraine” and representative of the international grain trader have been arrested as suspects in incurring damages to the state in the amount of UAH 1.6 billion. Uncovering of corruption scheme with alleged UAH 30 million in damages incurred by SOE “Energoatom”, 5 persons have been detained.
March	Head of Fiscal Service of Ukraine has been detained on suspicion in involvement in the “Onishenko gas scheme” case.
April	Former MP/former head of Parliament Committee on oil and energy sector has been detained on suspicion of involvement in the embezzlement of USD 17.28 billion at the SOE “Skhidny Girnichko-Zbagachuvalniy plant”.
May	Indictments against 8 persons in the “Onishenko gas scheme” case have been filed to court.
September	3 persons have been detained on suspicion in embezzlement and money laundering of over UAH 40 million from SOE “Ukrkhimtransamiac”.
October	Indictments against former CEO and deputy CEO of SOE “Derghzovnishinform”, which are suspected of embezzlement of UAH 9.87 million, have been filed to court. Former MP/former head of Parliament Committee on oil and energy sector and his possible accomplice (head of the department of the SOE) have been formally accused of taking over state assets from SOE “Energoatom” in the amount of EUR 6.4 million.
November	Four persons have been formerly accused of taking over UAH 20 million from SOE “Ukrzaliznichpostach” (currently, an affiliate of the Ukrzaliznitsya).
December	Indictments against the head of Fiscal Service of Ukraine and the head of the department on depts. resolutions in the Fiscal Service of Ukraine have been filed to court in relation to the “Onishenko gas scheme” case. Indictments against 5 persons in the criminal proceedings on damages incurred to SOE “Chervoniy zemlerob” in the amount of UAH 50 million have been file to court.
	Four persons have been detained on suspicion in regards to corruption scheme to embezzle money from State investment project and SOE “State Investment Company” in the amount of UAH 259.2 million.
	Former CEO of the SOE “Lutsky KXP #2” has been detained on suspicion of embezzlement of grains estimated at UAH 58.81 million.

It is also not surprising that an SOE-related case became the first large-scale operation once NABU was created in 2015. Today it probably remains to be the case which is most closely followed by the public and the international community and which would ultimately demonstrate what the new anti-corruption agencies can achieve in the criminal justice system of Ukraine. It will also demonstrate the “weak links” in current system.

Box 2 - “Onyshchenko gas scheme” case study⁴⁵

Alleged operations in the so-called case of the “Onyshchenko gas scheme” took place between January 2013 and January 2016 when a series of companies affiliated with Oleksandr Onyshchenko, then member of the Ukrainian Parliament, signed agreements with “Ukrgezvydobuvannya”, a 100% subsidiary of Naftogaz. According to these contracts the companies were going to invest in the development of exploration of gas and receive a part of the profits obtained as a result of such explorations. The State reportedly received UAH 25 million in profits over this period of time. The detectives of NABU have however estimated that in reality the State lost approximately UAH 3 billion. After the arrangements have been eliminated by NABU and SAPO the same SOE has earned a profit of UAH 560 million in only one year. This is 20 times more than the combined profits of 3 years when the scheme was in place.

The elaborate plan involved sales of gas at artificially reduced prices through several goods exchanges controlled by Onyshchenko to specific buyers, linked to Onyshchenko, which then re-sold the gas at market prices to real companies operating on the market. The price difference was taken out of the country using several legal entities also connected to Onyshchenko.

In June 2016 the first ten people were detained in connection to this case. Onyshchenko was under immunity as an MP and by the time the Ukrainian Parliament agreed to lift his immunity on July 5 2016, he fled the country. Documents requesting his arrest have been submitted to Interpol, however, for unknown reasons the issue of his international warrant of arrest has not yet been resolved.

In January 2017 two former deputy heads of the Executive Board of “Ukrgezvydobuvannya” and one of the department heads have been detained. Since then many of the persons involved in the scheme have agreed to cooperate with the investigation. Contracts between “Ukrgezvydobuvannya” and companies involved in the corrupt schemes have been terminated.

The case however had another angle – the investigation has established that companies affiliated with MP Onyshchenko received between May 2015 and March 2016 a deferral on monetary and rent payments for the use of lands in the amount of UAH 2.019 billion. This decision was taken personally by the Head of the Fiscal Service of Ukraine; it was backdated and lacking approvals by the Ministry of Finance. He was charged on 2 March 2017 and was temporarily suspended from his position by the CoM. He was released on UAH 100 million bail wearing an electronic bracelet. On 28 July 2017 the investigation of this episode was finalised and the case will be filed to court once the defence has reviewed the materials of the case.

This case can become a “poster-child” of enforcement success. For this, the outcome of court trials and court decisions in regards to all charged persons would be of high importance. The ability of the law enforcement to bring the final beneficiary of this scheme to responsibility can also help build public trust in the criminal justice system of Ukraine.

Challenges in detection, investigation and prosecution

Since NABU was established in December 2015 certain particular areas have gained prominence in their work. Corruption schemes in SOEs became one of such directions. Consequently certain informal specialisation within the units of detectives has also developed. There is for example a unit which specialises in SOEs under ownership of MEDT and another unit which focuses on issues of corruption in

⁴⁵ Information was taken from NABU annual reports for 2016 and 2017.

the energy sector. This is not a formal division of labour; however expertise on these issues is being built up and promoted within the Bureau.

The detectives are supported by analysts, who are irreplaceable in complex investigations, such as SOEs-related cases. They have a background as auditors, tax inspectors, financial analysts, etc. At the time of the establishment of the Analytical Department the number of cases was still small and the analysts did a lot of proactive work, including uncovering potential corruption in SOEs. This has changed: NABU detectives shared that the number of analysts is at present much smaller than that of detectives (there are approximately 200 detectives and 30 analysts) and they are getting overloaded with various requests and tasks and are in high demand.

The procedural law requires that the amount of damages be estimated. This is especially relevant to the cases of public procurement abuses in SOEs. There is an outdated methodology to calculate damages in Ukraine which needs to be aligned with international good practice.

For these purposes outside expertise is difficult to obtain. For example the State Audit Service is not very willing to calculate damages incurred by SOEs as a result of corruption schemes. Official experts from the Ministry of Justice are also difficult to engage and since October 2017 following the amendments of the Law on Judicial Expertise private experts can no longer be used. So again analysts of NABU are being utilised for these purposes.

International Cooperation

Some of the top SOEs in Ukraine are increasingly operating outside of the country and corruption schemes involving SOEs span across multiple jurisdictions. Effective international cooperation is very important for successful investigation of SOEs sector corruption.

Such cooperation seems to actively take place in corruption investigations involving SOEs. For example, in the investigation of the embezzlement of funds in SOE “Skhidny Girnicho-Zbagachuvalniy plant” and in Energoatom 53 requests for mutual legal assistance have been sent to foreign jurisdictions by NABU. This is the biggest number of such requests ever made in the framework of one investigation. The investigation was completed in the beginning of 2018, thanks to effective international cooperation which provided necessary information on the details of the used legal schemes and the means of money laundering. As a result the former Head of the Parliament Committee on Oil and Energy Sector could be charged.

There are many other such examples and this practice should be continued and further developed.

In conclusion, there are already examples of real enforcement in regards to corruption in SOEs. However, the number of cases is still not comparable to the number of SOEs and allegations of corruption in the sector. Enforcement of these crimes should be further strengthened – at all levels. Perhaps operations sweeping the whole sector or industry should be undertaken to break down the well-established schemes. NABU should be provided with necessary resources to do so, including more analytical capacity and better access to other official experts. Methodological guidelines on most challenging and complicated issues need to be developed and adopted. Guidelines in terms of calculation of damages could be a good starting point. International cooperation in corruption cases that involve SOEs should be continued and further improved. And finally court practice should be followed up to see what challenges will emerge at the stage of adjudication and how they could be best addressed.

Recommendation 16

Further strengthen enforcement of SOEs-related criminal cases at all levels, in particular:

- Consider undertaking operations sweeping the whole sector or industry to break down the well-established schemes.
- Provide NABU and SAPO with necessary resources to do so, including increasing analytical capacity and better access to other official experts.
- Update methodological guidelines on most challenging and complicated issues, such as calculation of damages.
- Continue and further improve international cooperation in corruption cases that involve SOEs.
- Follow up on court practice as it develops to identify and address emerging challenges at the stage of adjudication.

4.5. Case-study of “Naftogaz”

State-owned assets in the Ukrainian oil and gas sector are essentially controlled by one company, National Joint-Stock Company Naftogaz of Ukraine, which at least in the gas sector accounts for almost 100% of the revenues and is also the largest group of companies in Ukraine. Naftogaz, established in 1998 to manage state-owned oil and gas assets, controls most of the domestic oil and gas extraction and the entire transportation and storage infrastructure. Naftogaz’s key subsidiaries include Ukrnafta (an oil producer, majority owned by Naftogaz); Ukgazvydobuvannya (the largest producer of gas and gas products); Ukrtransnafta (oil pipeline operator); and Ukrtransgaz (gas pipeline operator).

The Law of Ukraine “On the natural gas market” effective as of 01 October 2015 introduced Third Energy Package-complaint requirements on the gas transmission system operator unbundling (TSO), e.g. its separation from other activities of vertically integrated undertakings, such as production and supply of gas and electricity. In July 2016 the Restructuring Plan of Naftogaz was adopted but with the outcome of arbitral proceedings between Naftogaz and Gazprom at the Arbitration Institute of the Stockholm Chamber of Commerce changes may be required.

According to the data of the report of MEDT for the first 6 months of 2017, the largest part (51 %) of the aggregated net revenue of the Top 100 SOEs was generated by Naftogaz. In the first half of 2017 its net revenue was UAH 122.8 billion, which is 41% higher than in the first half of 2016. It was estimated to have the biggest effect on all economic indicators in the first half of 2017: it accounted for half of EBIDTA and 73% of the financial results (earning UAH 23.3 billion of total UAH 32.6 billion).

Naftogaz is the biggest payer of taxes and dividends in Ukraine. In 2017 it paid a total of UAH 107.3 billion in taxes and dividends to the State budget, and in the first four months of 2018 it already paid about UAH 43.0 billion, which accounted for 19.3% of the total revenues of the State budget over this period.

The company also carries out a public service obligation (further – PSO) function: it is required to purchase natural gas from affiliated gas production companies to cover the needs of designated categories of consumers (including households and district heating companies), to sell this gas to local intermediaries which then resell it to households and to supply this gas to district heating companies. The sale of gas to local intermediaries as well as to district heating companies is made at prices set by the Government; certain conditions are imposed for district heating companies to receive the PSO gas while almost zero conditions are provided for the sale of gas to local intermediaries which (except for one) do not belong to Naftogaz Group and are private entities associated with notorious oligarchs.

Prices for households and district heating companies historically represented only a third to fourth of industrial gas tariffs but accounted for more than a half of the total domestic gas consumption. In 2014, CoM launched the gas market reform which assumed steady liberalization of the gas market, abolishment of PSO and introduction of targeted subsidies. In line with this reform, starting from 1 May 2016, the PSO gas price was increased to reach the market level. However, since then further liberalization of residential gas prices has been postponed. Due to the political sensitivity of this issue, especially in the view of the upcoming elections, the Government is reluctant to bring them to the market level.

To sum up, the current PSO regime imposed by the Government is the major source for accumulation of debt and related financial and operational issues of this SOE.

It should be expressly noted that Naftogaz is not an example of the average Ukrainian SOE, incorporated as a JSC, but a privileged pilot project by the Government of Ukraine. Naftogaz has been selected by the Government as a flagship company for corporate governance reform. In particular, its reform is being benchmarked according to the OECD SOE Guidelines as per the corporate governance action plan developed in view of meeting loan conditionality of the EBRD. Consequently the following description of practices implemented or planned to be implemented in Naftogaz must not be generalized to the whole SOE sector since these practices differ significantly from those applied in most Ukrainian SOEs and especially in SOEs established as unitary enterprises.

4.5.1. The State as the shareholder of Naftogaz

Naftogaz is incorporated as a public joint stock company (JSC) under the Ukrainian Law on Joint Stock Companies. Naftogaz is 100 % owned by the state of Ukraine represented by the CoM.

In 2015, the Government embarked on a corporate governance reform of Naftogaz developed in line with the OECD Guidelines. In October 2015 the CoM approved the Corporate Governance Action Plan for Naftogaz (CGAP). 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 OECD Guidelines - this was part of an agreement with EBRD, creditor of Naftogaz.

In December 2016 the CoM approved two new versions of the Charter of Naftogaz, one which was to enter in force immediately and the draft Charter, as well as Regulations of the Supervisory Board and Regulations of the Executive Board. The draft Charter included provisions which were not yet taken into account in Ukrainian legislation at the time. They included, inter alia, competence of the Supervisory board on the appointment and termination of the powers of the Executive Board members, the approval of the strategy and of the financial and investment plans etc. The draft Charter was to become effective on 1st April 2017. However, in March 2017 the Government decided to postpone the effective date of the draft Charter and Regulations until the respective amendments to the legislation have been made.

In the course of the implementation of the CGAP the Government decided to elaborate and approve the required amendments to legislation in two stages. As a result, in June 2016 the Law 1405 came into effect, making establishment of Supervisory Boards obligatory for the SOEs which meet the set minimum criteria. The majority of the members of the Supervisory Boards should be independent. The Law also included requirements regarding disclosure of information by SOEs, audit of financial statements, etc. With the adoption of this law any member of the Supervisory Board could be elected as its Chair and not only the representative of the State, as was the case previously.

However the reform seems to have stopped and some crucial aspects have been left unaddressed,

including:

- Development and submission for approval by the Parliament of draft laws ensuring initial *insulation from political meddling and graft* in line with international standards. The draft Anti-meddling Law which was submitted by Naftogaz as a part of CGAP was left by the government unattended.
- The status of Naftogaz subsidiaries remains unclear. The legal ownership by Naftogaz of its subsidiaries and other assets and corporate rights contributed to its share capital is being disputed by the State and should be officially confirmed;
- The Supervisory Board did not get the powers to approve the strategy and the financial and investment plans of the Company, to appoint and dismiss the CEO. Instead, these continue to be approved by the CoM in plenary meetings;
- The payment of dividends by Naftogaz is not based on the consolidated financial statements of the Naftogaz Group and some of Naftogaz subsidiaries continue to pay dividends to the State and not to the mother company;
- The obligatory dividend rate applied for all SOEs continues to have no regard to the profitability and the financial position of the companies.

Currently Naftogaz continues to operate under the Charter adopted in December 2016 and there is no clear commitment on the continuation of the reform.

In April 2017 the Chairman and in September 2017 three independent members of the Supervisory Board of Naftogaz submitted their letters of resignation because they did not see any real progress of the promised reforms. They also directly referred to increasing political interferences in the operations of the company, including interference with the role of the CEO and other employees and with the process of unbundling, appointment of executives and senior staff dismissed from Naftogaz to key government positions, etc.⁴⁶

The ownership of Naftogaz has been transferred between three different authorities in the last five years, including Ministry of Energy and Coal, MEDT and since September 2016 the CoM.

The Charter of Naftogaz includes a list of 26 items which are reserved to the powers of the General Meeting, i.e. the CoM, inter alia:

- Amendments to the Charter;
- Appointment and removal of the Supervisory Board members and the CEO;
- Approval of strategic development, financial and investment plans;
- Decisions regarding the increase or decrease of the company's share capital
- Approval of the Annual Report
- Decision regarding the distribution of the company's profits or losses and the amount of annual dividends
- Approval of any material transaction with a value exceeding 25 % of the Company's assets
- The approval of the corporate governance code of the Company.

⁴⁶<http://www.naftogaz.com/www/3/nakweben.nsf/0/6D7C544D5F376866C22581A0006883A0?OpenDocument&year=2017&month=09&nt=News&>

With the exception of approving strategic development, financial and investment plans and the appointment of the CEO these powers are in line with the Law on Joint-Stock Companies.

The CoM decisions in the capacity of Naftogaz Shareholder require the preliminary review and approval by a number of ministries, including at least MEDT, the Ministry of Finance (MoF) and the Ministry of Justice (MoJ), also sometimes the Ministry of Energy and Coal Industry (MECI). MoF approves financing applications for loans, issues, guarantees, etc. MECI authorizes the management of state assets on the balance sheets of Naftogaz and its subsidiaries and is responsible for the approval of investments, new construction projects, etc.

There are other State institutions exercising control or regulatory functions over Naftogaz. In particular, the **State Audit Service** is responsible for the approval of all transactions and payments exceeding certain thresholds, it has a permanent post in the Company and some subsidiaries. The **National Commission regulating Energy and Utility Sectors** has a major impact on Naftogaz operations and financial performance having the authority to approve long-term development plans for the gas transit and transmission system and storages, setting tariffs, driving the market reform through legislature, including the Network Code and having a role in the unbundling process and operator certification. The **State Service of Geology and Subsoil Use of Ukraine** issues special permits for subsoil use, controls compliance with their requirements, and is empowered to suspend or terminate such permits. The **Ministry of Ecology and Natural Resources** approves documentation submitted in order to obtain special permits for subsoil use. The **State Service on Mining Supervision and Industry Safety** designates the relevant land plots as mining allotments for oil and gas extraction and controls the compliance with safety requirements for gas processing and transportation facilities.

According to Naftogaz there are currently no established lines and rules of communication between Naftogaz and its Shareholder, this being a collegial body. It is not uncommon for any Ministry or even a department within the Government to directly contact Naftogaz “in their capacity as the Shareholder” with requests for information or instructions. On the other hand when Naftogaz needs a decision of the Shareholder in regards to, for example, its gas supply transactions or the adoption of KPIs for the Supervisory Board, it has to address different levels and functions within the Government.

Naftogaz also points out that the Company is not allowed to participate in practice in the development and planning of various decisions and policies which relate to it. Most documents are communicated to Naftogaz through official correspondence in the form of resolutions and decisions of the CoM.

The review and approval of financial plans by the CoM is reportedly done without real consultations with the Company and without any regard to its operations. For example, the financial plans of Naftogaz and its subsidiary companies are not reviewed simultaneously resulting in situations where the plan for Naftogaz might be approved but the respective plans for the subsidiaries might not. This, in addition to serious delays in approvals impedes the operations of Naftogaz.⁴⁷

The Corporate Strategy of Naftogaz was developed in 2017; it was endorsed by the Supervisory Board and submitted for review and approval to the CoM in July 2017. The CoM has not approved it as yet and has

⁴⁷ 2014 financial plan was approved on 24 December 2014; 2015 financial plan was approved on 23 December 2015; 2016 financial plan was approved on 11 November 2016; and 2017 plan has not been approved as of beginning of 2018

not engaged in any discussions of this document. Non-approval of the Corporate Strategy complicates the priority setting, business planning and performance management of Naftogaz' management.

Conversely, the Government shared that Naftogaz Supervisory Board is not always forthcoming either. When the new Supervisory Board had been established the CoM sent them a draft letter outlining the expectations of the owner but this letter was reportedly left without a response.

In sum, in order to maintain the pace of corporate governance reforms in Naftogaz and to ensure better functioning of the company, the government and company should take necessary steps to have on-going dialogue. The government should be encouraged to play an active role as shareholder, while also empowering supervisory board to strategically guide the company and executive management.

4.5.2. Naftogaz Supervisory Board

Naftogaz first independent Supervisory Board was appointed in April 2016 and it consisted of five members, three independent directors and two Government appointees. In March 2017 the Government increased the number of the Supervisory Board members to seven. However, between April and September 2017, a number of Supervisory Board members resigned, including three independent directors and one Government appointee.

Currently the Supervisory Board of Naftogaz comprises of seven members⁴⁸, four of which are independent directors and three Government appointees. The following independent directors have joined the board: Clare Spottiswoode (Great Britain), Bruno Lescoeur (France), Amos Hochstein (U.S.) and Steven Haysom (Canada). In addition, the Government has appointed Volodymyr Kudrytskyi (Ukraine) and Serhij Popyk (Ukraine) to represent the Government on the Board together with Volodymyr Demchyshyn (Ukraine) who has served on the Board since its establishment in 2016.

The Supervisory Board members are appointed from among capable individuals for the period established by the General Meeting of the Company, unless otherwise provided by law. Any member may be re-appointed more than once. No Supervisory Board member can be a member of the company's Executive Board or other corporate body at the same time. The Chair of the Supervisory Board is elected by the Supervisory Board members from among themselves by a simple majority vote.

All Supervisory Board members are appointed directly by the Shareholder, i.e. the CoM. At the same time, candidates for positions of independent directors are selected by a Selection Commission and a Nomination Committee, appointed by the Government. The set procedure however was not followed in the case of the present Supervisory Board, as the Government was reportedly under pressure to appoint new members quickly.

Following the most recent amendments to the Law on Joint-Stock Companies, the Supervisory Board, particularly the Nomination Committee, will be in charge of developing a succession plan for the Supervisory Board and may be entitled to propose to the Shareholder the candidates for new Supervisory Board members.

⁴⁸ The government appointed four independent directors and three government appointees in December 2017, thus forming a new Supervisory Board of seven members.

Main functions of the Naftogaz Supervisory Board

According to the present Charter of Naftogaz the Supervisory Board has, inter alia, the following powers and duties:

- giving notice to convene the annual General Meeting as well as extraordinary General Meetings;
- approving securities issues in a value of maximum 25 % of the total assets of the Company;
- approval of the terms and conditions of contracts to be entered into with the CEO and Executive Board members and determination of their remuneration. However these officers are to be appointed by the Shareholder;
- appointment of the Company's external auditor;
- making decision on approval of any material transaction, if the value of the transaction amounts to 10 to 25 per cent of the Company's assets. Transactions valued at less than 10 % are within the powers of the Executive Board whereas transactions valued in excess of 25 % are to be decided by the Shareholder;
- taking decisions regarding related party transactions;
- establishment of Supervisory Board committees;
- appointment or removal of Corporate Secretary, Risk Management Officer, Compliance Officer, Anti-Corruption Officer, Chief Audit Executive;
- pre-approval of draft annual accounts to be approved at the General Meeting;
- annual evaluation of its performance and preparation of the Annual Report of the Supervisory Board.

The Supervisory board of Naftogaz has established four Committees dealing with audit and risks, ethics and unbundling, remuneration and nominations, health safety and environment.

The newly established Supervisory Board will need to be truly empowered to carry out its functions, including receiving powers to approve the strategic, financial and investment plans. A constructive dialogue with the Government will be of key importance.

4.5.3. Naftogaz CEO and the Executive Board

The CEO of Naftogaz is appointed from among capable individuals who are not Supervisory Board members. Under the current Charter the CEO is appointed by the General Meeting upon a submission by the Supervisory Board. The term of appointment of the CEO is determined by the resolution of the General Meeting.

The day-to-day management of the Company is vested to the Executive Board headed by the CEO. Powers of the Executive Board and the CEO are set up in the Charter. CEO Deputies run operational units of the Company and are responsible for the daily management of the business transactions. As part of the Corporate Governance Action Plan risk management, compliance and financial control functions have been created to support decision-making and to control business transactions. Internal audit acts as an independent unit to oversee the Company's internal control system.

4.5.4. Remuneration

The terms and salaries of the CEO and Members of the Executive Board of Naftogaz comply with Regulation #859 of the CoM "On conditions and wages of managers of enterprises, based on state, municipal property, state enterprises and associations". According to the latest amendments to Regulation #859 salaries of chairs and members of management boards of public joint stock companies created in the process of corporatization of state enterprises consist of the following components:

- basic salary;
- bonuses for the results of the quarter and for the full year;
- material compensation for the effective management of State property;
- supplements to the base salary for academic degree and for academic rank.

The salary rate of the CEO is defined according to the average number of employees, the value of assets or net income from sales of goods, works or services, according to the latest annual financial statements and the multiplicity of the minimum base salary rates of main occupation employees of the Company.

4.5.5. Financial control

Since 2016 there is an independent internal audit function in Naftogaz that provides independent monitoring and assurance services for the most critical business processes and areas in Naftogaz and its subsidiaries. It controls their performance in accordance with the objectives, the implementation of operational controls, the efficiency and effectiveness as well as the compliance with corporate governance standards.

The internal audit department is headed by the Chief Audit Executive who is subordinate to the Supervisory Board through the Chair of the Audit and Risks Committee. The internal audit department acts independently from the external auditors. The regulations on the internal audit department, their code of ethics and other methodical documents have been approved and enacted at the end of 2017 and currently the Chief Audit Executive implements all procedures and methodologies in the companies of the Naftogaz Group.

The Audit Committee of the Supervisory Board of Naftogaz was established in September 2016 and its regulations have been amended to meet the new requirements of the law in February 2018, also renaming the committee to Audit and Risks Committee.

The financial statements of Naftogaz are subject to external audit by an international audit company, currently Deloitte. Deloitte conducts the audit in accordance with International Standards on Auditing ("ISAs"). Deloitte is independent of the Group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (the "IESBA Code").

Additional control is performed by the State Audit Service. According to a resolution of the CoM the State Audit Service verifies and signs on all contracts and payments by state and municipality owned companies in the amount exceeding 100k UAH. As pointed out in earlier sections, the omnipresent role of this state audit body directly in the company, duplicating the company's system of internal controls, runs counter to good practice and that which is expected of a fully corporatized state-owned company, such as Naftogaz.

Naftogaz and its subsidiaries prepare their financial statements according to International Financial Reporting Standards IFRS. The Law On Accounting and Financial Reporting requires that companies of public interest disclose annual financial statements and annual consolidated statements together with the audit report on their website. Naftogaz publishes such information on its website.

Naftogaz also complies with the requirement of the CoM⁴⁹ to disclose:

- Quarterly financial statements (including consolidated) for the last 3 years, including expenses for non-commercial targets of the state policy and sources of their funding;
- Annual financial statements (including consolidated) for the previous 3 years, including expenses for non-commercial targets of the state policy and sources of their funding;
- Audit opinions on annual financial statements for the last 3 years.

4.5.6. Transparency and disclosure

The Policy on Transparency and Disclosure of Naftogaz was approved by the Supervisory Board in September 2016.⁵⁰ The Company discloses information in accordance with the disclosure requirements set by several general Laws of Ukraine and Laws specific to the energy sector, as well as generally accepted good practices for transparency and disclosure by SOEs, such as those promoted by the OECD SOE Guidelines.

Information on the operations and business of an SOE shall be subject of public disclosure in accordance with the Laws of Ukraine. In particular, this includes financial and statistical reporting, information on over threshold procurement of goods, works and services and data to be disclosed under the Law on Access to Public Information.

In addition the following information is disclosed by Naftogaz on a voluntary basis:

- information about actions and events that have a material effect on the operating income or the assets of the Group;
- information on decisions or events which, in the opinion of the management, have or may have a material impact on the implementation of any of the key areas of the strategy of the Company or any of the companies of the Group;
- regular statistical information about the Company's activity, companies of the Group and the oil and gas market of Ukraine;
- information about transactions for goods or services with related parties except where such transactions are for an open tender or auction in the ProZorro electronic public procurement system;
- information about changes in the composition of the Executive Board of Naftogaz or enterprises of

⁴⁹ CoM Resolution #1067 from 9 November 2016.

⁵⁰ Approved by the decision of the Supervisory Board in September 2016

the Group;

- annual declaration of the property status and income of Naftogaz` Chief Executive Officer;
- information which is not material to the financial performance of the Company or the implementation of its strategy, but, according to the management, has or could have significant public interest.

Information on participation of any JSC in other legal entities shall be included into the regular quarterly and annual information. This information should be disclosed through a submission to the National Securities and Stock Market Commission (NSSMC) and placed on the company's website. Naftogaz complies with this requirement. It also discloses information about the financial and non-financial performance of its subsidiaries in the Annual Report.

Information identified as confidential in agreements with contractors is not subject to public disclosure. Naftogaz discloses information to statistics and control authorities in accordance with applicable laws. Other information that is not required for publication in accordance with applicable laws and the disclosure of which, according to the reasonable opinion of the management, would prejudice the interests of the Company in negotiations or undermine business activities is not disclosed.

For information purposes Naftogaz uses its own resources, corporate websites www.naftogaz.com and www.naftogaz-europe.com as well as its official pages of social networks Facebook and Twitter. Official reports of the Company are also distributed by the press service. The Company also discloses information through the media and NGOs.

As per good practice the Company prepares an Annual Report, which is an important document on the operations and performance of Naftogaz and contains consolidated financial statements. The Annual Report also contains a section on the Company's activity in the field of corporate responsibility.

Naftogaz is open to participation in leading transparency platforms related to the business of the Company or its subsidiaries. After the entry into force of the Law "On the natural gas market", which meets the requirements of the EU Third Energy Package, the Company has committed to conduct outreaching measures to explain the new rules of the gas market. These measures include holding press conferences and meetings of the Company's management with target audiences.

The Company is working to increase transparency in the energy sector by publishing with open access on the platform of the European Network of Transmission System Operators for Gas (ENTSO-G) and on the official Ukrtransgaz website of daily reporting on the Ukraine's work with European partners. Naftogaz is open to participation in other leading transparency platforms related to the activities and business of the Company or its subsidiaries.

Naftogaz is involved in the development and actively supports the promotion of a draft law on transparency in the extractive industries.

4.5.7. Anti-corruption measures

Naftogaz approved the new version of the Anti-Corruption Program in May 2017, developed in compliance with the requirements of the CPL as well as international legislation and practices, including the OECD Anti-Bribery Convention, the Foreign Corrupt Practices Act of 1977 and the UK Bribery Act 2010.

The Company continues the reform on corporate governance. In particular, the Company has recently established several internal control functions: audit, risk management, financial control and compliance and is improving their capacity. Holding an open competition for the selection of candidates for the position of the Compliance Officer has been positively noted in TI-Ukraine Corporate Transparency report. Naftogaz was named as one of the two SOEs aiming to build a meaningful compliance function.

Naftogaz top management has been actively involved in various international and regional forums championing the need for anti-corruption measures – this sends the right message of the tone from the top.

Naftogaz has already developed and adopted the following compliance tools:

- Code of Corporate Ethics;
- Anti-Corruption Program;
- Compliance Program;
- Conflict of Interest Policy;
- Compliance Risk Management Policy;
- Regulations on Compliance Office and Chief Compliance Officer.

The Code of Corporate Ethics and the Anti-Corruption Program were placed on the Company's website <http://www.naftogaz.com>. All compliance documents were reportedly placed on the Company's internal website accessible to all employees.

The following compliance instruments are currently fully functional in Naftogaz:

- Counterparties due diligence (KYC): Compliance Office reviews the counterparties for compliance risks before conclusion of any agreements or contracts with them.
- Declarations of conflicts of interest and gifts.
- Whistleblowing hotline.
- Compliance investigations.
- Employee training on the Code of Corporate Ethics and Anti-Corruption Program issues.

It must be mentioned that a compliance function has been introduced also in those Naftogaz Group companies where the Company is the sole shareholder.

4.5.8. Procurement of goods and services process description of the Naftogaz Group

Procurement of goods and services by Naftogaz and its subsidiaries required to apply the Law on Public Procurement is performed in line with the Law "On public procurement" and the "Procedure for procurement of goods, works and services of the National Joint Stock Company Naftogaz of Ukraine, subsidiaries and economic partnerships, where National Joint Stock Company Naftogaz of Ukraine is a shareholder" ("the Procedure").

Description of the main stages of the procurement process in Naftogaz Group using the electronic procurement system:

1. Approval of the financial plan by the Shareholder,
2. Approval of the annual procurement plan within the limits stated in the financial plan,
3. Procurement application preparation by the unit responsible for determining the need for goods, works or services to be procured in accordance with the annual procurement plan,

4. Decision to conduct procurement (approval documents),
5. Procurement procedure performance (announcement of the purchase, qualification of participants, choosing the winner of the procurement procedure),
6. Approval of the contract (by the Shareholder when required),
7. Conflict Commission Decision in the case of complaints by procurement procedure participants or other stakeholders,
8. The conclusion of the purchase,
9. Execution of the purchase agreement.

The conditions of the purchase agreement, including the unit price, should not differ from the content of the tender by the winner of the auction or from the offer price in the case of a negotiating process. Significant terms of the purchase agreement cannot be changed after it has been signed, except in certain cases in favour of the purchaser and in cases of force majeure or of increase of taxes or official payments.

Naftogaz publishes information concerning procurement on its official website and on the ProZorro platform in line with the requirements of the Law "On public procurement". This information contains in particular the total quantity of tenders carried out, the planned amount of expenditure and the savings incurred.

Naftogaz joined the pilot project ProZorro in June 2015. The Law "On public procurements" took effect in April 2016. During all 2016, Naftogaz performed procurement only through ProZorro when 63% of all procurements were below-threshold and 37% were over-threshold procurements or so-called Tender procurements. During 2016, below-threshold procurements were performed through direct contracts (23%) as well as through auctions (77%).

From the beginning of 2017 till reporting date ProZorro procurement statistics of Naftogaz is 48% below-threshold procurements and 52% over-threshold procurements. During 2017 below-threshold procurements were also performed through direct contracts (37%) as well as through auctions (63%). All in all, Naftogaz carried out more than 11,000 tenders through the ProZorro system and saved more than UAH 6, 6 billion.

It must be noted that the ProZorro system is not applied to procurements, which are not covered by the Law "On public procurements", in particular:

- goods, works and services procured as a state secret in line with the Law "On State Secrets";
- services necessary for the implementation of public borrowing, servicing and repayment of public debt;
- purchase, lease of land, buildings, or other immovable property or property rights in land, buildings or other real estate;
- services of international arbitration, international commercial arbitration for consideration and resolution of disputes involving the customer;
- services by financial institutions, including international financial institutions to provide loans, guarantees, leasing and services auxiliary to financial services;
- financial services provided in connection with the supply, purchase, sale, transfer of securities or other financial instruments;
- forms and other documents, which according to the legislation of Ukraine require the use of special security features, brand excise tax produced by enterprises belonging to the central executive body that implements the state policy in the sphere of organization and control of the production of forms of securities, documents of reporting as well as goods and services needed for their production;

- services in proceedings of scientific, technical activities funded on a competitive basis in the manner specified in the Law "On scientific and technical activity";
- goods, works and services directly produced, performed, are provided for the activities in specific areas of management of affiliated companies;
- fuel and energy resources to produce electricity, heat, conduct geological exploration of mineral deposits;
- goods purchased for resale to third parties, provided that the customer is not the monopoly (dominant) position on the market for such products, and other entities are free to exercise their sale under the same conditions as the customer;
- goods, works and services, if prices (tariffs) are approved by the state collective bodies, other authorities under their authority or determined in the manner prescribed by the said authorities, including determining if such prices shall auctions;
- goods, works and services for production sharing agreements entered into pursuant to the Law "On Production Sharing Agreements".

It is beyond doubt that Naftogaz benefited from being the flagship of the corporate governance reform for SOEs and from the adoption and partial implementation of the CGAP. However, success of the reform largely depends upon full implementation of its key elements, such as:

- *approval of the strategy;*
- *approval of the ownership policy in line with the OECD Guidelines;*
- *vesting Supervisory board and executive body of Naftogaz with the due scope authorities in line with best practices of corporate governance;*
- *resolving issues of dividends, removing abundant inspections and approvals, as well as all other inefficient state controls that prevent from providing a level playing field with other commercial companies, adoption of the required legislation.*

The example of Naftogaz illustrates very clearly that the efforts of the Government to "improve the corporate governance" will remain only of a declarative nature, as long as the general and structural issues have not been reorganized. Absence of political will and commitment cannot be afforded by Ukraine at this point in time and it should follow through on its plans and promises of true corporate governance reforms of the SOEs – Naftogaz is an excellent place to start. It is being watched closely domestically, as well as internationally and has become a test for real reforms.

4.6. Case-study of “Ukrenergo”

National Power Company “Ukrenergo” SE (Ukrenergo) is a 100% state-owned entity, with the corporate form of a unitary enterprise, responsible for operating the domestic high voltage transmission system and cross-border transmission lines. Ukrenergo's principal business is to deliver electricity from major electricity producers to regional distribution companies (oblenergots) and to connect the Ukrainian network system with those of the neighbouring states, as well as to provide technical support for the export and import of electricity. Ukrenergo controls the consumption of electricity and the exploitation of electricity facilities on behalf of the State.

Ukrenergo is essentially one of the three enterprises (in addition to nuclear power producer Energoatom and hydroelectric power producer Ukrhydroenergo), which dominate the second largest sector of Ukraine's economy – the electricity sector and it is the sixth largest SOE based on the net income indicator.⁵¹ Due to

⁵¹ According to the information from TOP 100 SOEs in the first 6 months of 2017.

its status as a natural monopoly, tariffs for the enterprise are set by the sector regulator, which uses a cost-plus approach to set tariffs based on the OPEX and CAPEX needs of the enterprise. Ukrenergo regularly conducts cross-border capacity auctions and sells rights to export electricity from Ukraine to neighbouring countries.

Historically, the enterprise has financed its CAPEX programs with loans from the EBRD and the World Bank. In 2015, Ukrenergo signed a USD 378 million loan agreement with the World Bank to finance the modernization of its power transmission network and to support the implementation of a wholesale electricity market in Ukraine. The loan will not only finance physical modernization but also help to put in place elements needed for a more efficient market-based electricity pricing system.

The financial performance of the enterprise has been consistently on the rise in the last years mostly due to the rise of energy tariffs. The EBIDTA of Ukrenergo in mid-2017 has grown to UAH 3.2 billion (65% increase compared to 2016); its net income has grown by 81%. Previously in 2016 Ukrenergo doubled its net income to UAH 2.2 billion in comparison to 2015. In 2017 Ukrenergo employed approximately 11500 persons.

Ukrenergo is also by no means an example of the average Ukrainian unitary enterprise. It hopes to become a successful example of corporatisation, introduce good corporate governance practices as recommended by the OECD, and to facilitate Ukraine's compliance with the European Network of Transmission Systems Operators for Electricity ENTSO-E.

4.6.1. The State as the owner of Ukrenergo

Ukrenergo is incorporated as a state-owned commercial unitary enterprise. It was created by the order of the Ministry of Energy of Ukraine in 1998 as a result of a merger of the National Dispatch Centre of Electricity Energy of Ukraine and the reorganized State Electric Company “Ukrelektroperedacha”. Ukrenergo is 100 % state-owned and the Owner is the Ministry of Energy and Coal Industry (MECI).

MECI approves the titles of the construction objects, five-year strategic development plans and investment programs of the enterprise. MECI, as Ukrenergo’s ownership entity, also has the powers to:

- decide on the establishment, reorganisation and liquidation of the enterprise;
- decide on the competitive selection of candidates for the positions of independent members of the Supervisory Board; develop recommendations regarding their qualification, experience and impartiality;
- determine and ensure the appointment or representatives of the State in the Supervisory Board; approve the terms of remuneration of Supervisory Board members ;
- approve the composition of the Supervisory Board;
- set or revise the objectives for the activities of the enterprise;
- establish performance indicators for the Supervisory Board;
- evaluate the results of the Supervisory Board’s activities according to these indicators and provide feedback to the Supervisory Board
- consider the feasibility of keeping the Supervisory Board if the enterprise ceases to fulfil the criteria based on which a Supervisory Board is obligatory for a unitary enterprise, and when appropriate initiate its termination;
- approve the Charter, the Regulation on the Supervisory Board, the Regulation on the principles of establishment of the Supervisory Board, and exercise control over the observance of the Charter;
- exercise control over the implementation of the investment and strategic plans;

- monitor the implementation of the financial plan;
- approve and enter into cooperation agreements, commission contracts, agency and asset management contracts, etc.;
- approve an anti-corruption programme and control the work on prevention and detection of corruption;
- enter into agreements for independent audit of the enterprise.

In addition to being the ownership entity of Ukrenergo, MECI is the main executive authority overseeing and regulating the power sector. The Ministry is a policy-setting body responsible for strategic development and production, consumption, CAPEX and capacity planning for energy and fuels, as well as drafting and implementation of sector reforms. Thus the Ministry combines essential regulatory tasks with corporate ownership which is against the OECD recommendations and generally accepted best practices.

The financial plans of Ukrenergo are also dealt with by the MoF and MEDT. Finally the CoM approves the financial plans, as well as construction of facilities of national importance with a total cost of over UAH 400 million.

Other authorities that exercise control over the electricity sector and have various responsibilities in relation to Ukrenergo include:

The **National Commission for Energy and Public Utilities Regulation (NERC)**, the main licensing and tariff setting body for producers and suppliers of electricity and heat, which issues, suspends and revokes licences, conducts regular and ad-hoc check-ups of licensed activities; develops standards for services provided by natural monopolies on the energy market and protects the interests of consumers in the markets operated by natural monopolies. In the electricity sector the NERC sets retail tariffs for all consumers (including household prices) based on projected electricity prices for the oblenegos and independent electricity suppliers. Household prices remain heavily subsidized and are not correlated with actual production and delivery costs, but their gradual upward revision was launched in 2015 and continued throughout 2017.

Energorynok is the state-owned wholesale electricity market operator, which essentially acts as a clearing centre that buys electricity from generators, calculates the average market price, sells electricity to distributing companies and independent suppliers and collects payments.

The **Antimonopoly Committee of Ukraine (AMCU)** is the State authority responsible for the safeguarding and enhancement of competition in Ukraine, which controls tariffs and prices for goods and services provided by natural monopolies. It is entitled to impose fines and apply other sanctions to the companies in breach of the rules of fair competition.

The **State Audit Service** and the **Accounting Chamber** have wide powers to control the management and the operations of the enterprise.

On a practical level, Ukrenergo reports having somewhat similar challenges to those of Naftogaz in terms of communication with the owner. In particular, it appears that the exercise of the ownership function is not well structured, communication lines with the ownership entity are not clear. Ukrenergo reportedly sends a letter to the Minister always when any decision or approval is needed; the Minister then assigns this letter to some department of MECI; that department circulates it to others for inputs, etc. There are no time limits for giving a response back to the enterprise and in practice these responses take very long time. To speed up the process Ukrenergo makes efforts to reach out to as many persons within MECI as possible

in order to find the responsible person. Decisions of the ownership entity are often ungrounded and make no economic sense. The monitoring team was provided with an example where Ukrenergo wanted to remove the representatives of the State Committee of Inspectors from the organisation and premises of the enterprise (approximately 1000 persons). MECI didn't approve, stating that such a measure is untimely.

The Law On Electric Power Sector and the Law of Ukraine On Electricity Market of Ukraine define the rights and responsibilities of the electricity system operator Ukrenergo. The Charter of Ukrenergo was approved by MECI in September 2017.⁵² The current Charter is the ninth amended version of the initial document adopted in 1998. The Charter defines the purpose and objective of the enterprise, the legal status, the assets in the "economic jurisdiction" of the enterprise, the authorized capital, the rights and obligations of the enterprise as well as the rights and duties of the Director, the Supervisory Board, the ownership entity and the corporate secretary.

Ukrainian state-owned unitary enterprises have no ownership over the assets included in their balance sheets. The ownership is retained by the State and assigned to the enterprise under the so called economic jurisdiction.

In November 2017 the CoM approved the reorganisation of the unitary enterprise Ukrenergo into a 100 % state-owned private joint-stock company. (Under Ukrainian civil law a "private" joint-stock company is a company whose shares or other securities are not publicly traded at the stock exchange or otherwise, as opposed to a "public" joint-stock company.) All property on the balance sheet of this unitary enterprise, which ensures the integrity of the united energy system of Ukraine, dispatching management, trunk and interstate power grids, should be assigned to the joint-stock company to be formed and not be subject to alienation.

For the purposes of such a reorganisation Ukrenergo should conduct a stocktaking of assets, carry out the assessment of the value of the entire property complex of the enterprise and issue shares to be transferred to State ownership. According to the Law On electricity Market of Ukraine Ukrenergo as an operator of transmission system should be incorporated as a JSC with state share 100% and it should be an owner of dispatching management system and interstate power grids. However, transfer of the legal ownership of such state-owned assets to an independent joint-stock company, albeit 100 % state-owned, would be considered privatisation. And according to Law on Privatization dispatching management system and interstate power grids cannot be privatized. This is a general problem which affects naturally also all other plans to convert unitary enterprises into joint-stock companies in some specific sectors (Energoatom, sea ports, airports etc.). Legislative changes would be required to separate production from grids and networks.

Ukrenergo also announced a corporate governance reform to ensure a competent and unbiased control over the management of the enterprise by the State, to organize unbundling in the electricity generation sector and to facilitate the Ukrenergo's integration into ENTSO-E.

The reform is planned to take place in two phases: the first phase would include the creation of an independent Supervisory Board with audit, nomination and remuneration committees. The second phase would ensure Ukrenergo's corporatisation and transformation into a private joint-stock company with unalienable stock. This reform is expected to result in increasing trust and legitimacy in Ukrenergo's relations with international business partners, decreasing political influence and increasing transparency of the operations and business of the enterprise.

⁵² MECI Order #599 from 22 September 2017.

It appears that the reorganisation and reform which was launched should be kept under close monitoring to ensure that it is properly implemented and not stalled. The announced goals should be diligently achieved. In the meantime, the efficiency of the current governance should be optimised; communications should be functional and speedy; the ownership entity should allow Ukrenergo to take day-to-day operational decisions without excessive interference.

4.6.2. Supervisory Board

Ukrenergo is currently undergoing the first phase of its corporate governance reform, which includes the setting up of the Supervisory Board and its committees.

The rights, duties and responsibilities of the Supervisory Board as well as the procedure for the appointment and dismissal of its members are regulated by the Civil and Commercial Code of Ukraine, the Law On Management of State Property, CoM resolutions, the Charter of Ukrenergo, the by-laws of the Supervisory Board and the Regulation On Principles for establishment of the Supervisory Board of Ukrenergo.

Ukrenergo's Charter has been already amended to include provisions on the Supervisory Board. According to these provisions the Supervisory Board of Ukrenergo will be composed of seven members, four of which should be independent. Their term in office is set at three years. Members of the Supervisory Board should meet the criteria provided in the Law on Management of State Property and in the Charter. The independent members should also comply with the criteria set by the CoM for independent members of Supervisory Boards of unitary enterprises. The Chair and Deputy Chair shall be elected from among the members of the Supervisory Board.

The composition of the Supervisory Board shall be finally approved by MECI on the basis of the Decision to Appoint State Representatives to Supervisory Boards and of the results of the competitive selection of independent members in accordance with the legislation of Ukraine.

On 2 January 2018, a competitive selection for the positions of independent members of the Supervisory Board of Ukrenergo was announced with a deadline for the submission of documents on 2 March 2018. However the CoM changed the procedure while the selection process was underway. Ukrenergo representatives expressed hopes that the Supervisory Board members would finally be appointed in the course of the summer.

Prior to the establishment of the Supervisory Board its functions are carried out by MECI as the ownership entity. Reportedly the Ministry is in no hurry to have the Supervisory Board appointed and to have the supervisory functions transferred to it.

Legislation, which is currently in force in Ukraine, limits the remuneration of members of the Supervisory Board with gradation depending on the size of the enterprise, which precludes selecting the best candidates to the Supervisory Board.

According to the Charter of Ukrenergo the Supervisory Board would represent the interests of the State and be responsible for the general oversight of the enterprise, which would include defining the main purpose of Ukrenergo's activity and approving its strategy. It would control the performance and financial results of Ukrenergo by monitoring the implementation of the strategy and plans. The scope of the Supervisory Board's competence would also include determining KPIs for the management and controlling that they are met. The Supervisory Board shall, at a minimum, establish an Audit Committee and a

Nomination and Remuneration Committee and facilitate the functioning of relevant control systems (risk management, financial and operational control and compliance with law).

Establishment of the Supervisory Board at Ukrenergo will be an undeniably positive step. It is important however, that qualified persons are selected into the Supervisory Board, that it is afforded with the necessary powers to exercise its functions, that it is accountable while no undue interferences into its functions take place, and that it works constructively and effectively with the ownership entity and the CEO.

4.6.3. Ukrenergo's CEO

The CEO of Ukrenergo is responsible for the entire operational activity, development strategy, investments and international cooperation. His powers and obligations are stipulated in the Charter of Ukrenergo. He acts on behalf of the enterprise and in accordance with the laws, the Charter, Companies regulations as well as decisions of the Supervisory Board and of the ownership entity. He is accountable to the Supervisory Board, once it is established, and to the ownership entity.

The CEO of Ukrenergo is appointed among capable individuals, who are not members of the Supervisory Board, through a competitive selection procedure approved by the CoM⁵³ and initiated by the order of MECI. By the Order of MECI on 2 October 2015 Vsevolod Kovalchuk, who was the First Deputy Director at the time, was appointed to temporarily fulfil the duties of the CEO as an acting CEO until the appointment of a CEO in the established manner.

The selection procedure for the appointment of the CEO of Ukrenergo was finalised in May 2016. However, the results of this selection process have been annulled by a Court in December 2016 due to violations of the procedure. The selection committee members have been changing throughout the procedure, candidates have been interviewed multiple times and reportedly the final candidate was not among those on the initial list of candidates. It seems that a new procedure has not yet been initiated. Setting up of the Supervisory Board and its committees should remedy this situation, because according to Ukrenergo's current charter, CEO is appointed by the Supervisory Board.

Reportedly there are at present no safeguards against political or other undue outside interference or pressure on the CEO of Ukrenergo. However, the adoption of the new Ukrenergo Charter, which provides for the creation of a Supervisory Board, is hoped to eliminate the present day-to-day interference in the activities of Ukrenergo and its CEO, in particular.

The acting CEO has been temporarily carrying out these duties for almost three years. This issue needs to be properly addressed as his temporary status might expose him to higher risks of political pressure. It will be also important to ensure that he works constructively with the Supervisory Board, once it will be established in Ukrenergo.

4.6.4. Remuneration

The CEO of Ukrenergo, subject to standards and safeguards provided by the Law and the collective agreement, confirms the form and system of remuneration in the enterprise, establishes specific amounts of salaries, remunerations, allowances and additional payments to the employees, applies financial and other

⁵³ CoM Resolution #777 from 3 September 2008.

incentives and sanctions.

The salary of the CEO is defined in line with CoM requirements⁵⁴ and is calculated based on the value of assets, the annual net revenue of the enterprise and the number of personnel, multiplied by the minimum salary of an employee of the main profession in the enterprise.

Salaries of other executives are defined in line with a grade assessment system, developed in collaboration with Ernst&Young, which is outlined in the current collective agreement.

The terms of the remuneration of the Supervisory Board members shall be approved by the ownership entity, in line with the procedure established by law.

4.6.5. Financial control

The internal financial control of Ukrenergo is conducted by the Financial Control Unit which is subordinate to the Head of the Department of Economic Security. It ensures the effective operational functions of Ukrenergo and of its separate subdivisions in order to protect its legal property interests, to improve the accounting, as well as to contribute to the effective operation of the enterprise and to strengthen its financial state.

The Financial Control Unit plans, organizes and conducts financial control in the form of revision and financial audit; it develops recommendations on how to eliminate drawbacks and to prevent them in future.

The results of the financial control are submitted to the Head of Department of Economic Security. He evaluates and decides whether detected wrongdoings need to be referred to law enforcement authorities and whether audit materials should be submitted to them. The Financial Control Unit does not cooperate with the external auditors.

According to the Regulation on Supervisory Board of Ukrenergo⁵⁵, an Audit Committee shall be established by the Supervisory Board. The Audit Committee will:

- control the completeness, authenticity and timeliness of preparation of financial statements;
- prepare and submit recommendations to the Supervisory Board pertaining to the incorporation of the internal audit function and specification of effective internal audit procedures;
- prepare and transmit to the Supervisory Board recommendations concerning the election of an independent auditor and
- prepare and transmit to the Supervisory Board its opinions and recommendations for the appointment and termination of powers of the head of the internal audit function.

Ukrenergo's financial statements are compliant with the National Financial Reporting Standards.

The annual audit of Ukrenergo's financial statements is conducted by the external auditors in line with the IAS. Ukrenergo has been undergoing financial audits by international audit firms since 2005. The 2016

⁵⁴ CoM Resolution #859

⁵⁵ Approved by MECI Order #700 from 14 November 2017

audit was performed by Deloitte and Touche. Audit reports starting from 2012 can be found on the website of the enterprise.

Additional control is performed by the following state authorities:

- NERC (quarterly reporting, annual inspections of Ukrenergo regarding compliance with the tariff structure and implementation of the investment program).
- MECI (quarterly and annual financial reporting).
- State Audit Service conducts inspections once in two years; the latest inspection took place in November 2017.

Information and indicators of various aspects of Ukrenergo's operations and business are disclosed in a number of financial, economic, auditor's and technical reports, which are regularly published on the website. In addition, Ukrenergo issues an annual presentation report offering consolidated information regarding the activity and performance results of the enterprise.

4.6.6. Transparency and disclosure

The Information Policy of Ukrenergo was approved in February 2018.⁵⁶ According to this document the CEO defines the policy and its implementation is the responsibility of the Chief Communications and International Cooperation Officer and his unit.

According to this policy information to be disclosed includes (but is not limited to):

- Tasks and goals of Ukrenergo and their fulfilment.
- Results of financial and operational activities of the enterprise (operating expenses and sources of their financing, financial plan, balance sheet, profit and loss account, cash flow statement and annexes to the financial statement, etc.).
- The structure of management, ownership and voting procedures, corporate governance policies and their application; any special rights or agreements that differ from generally accepted corporate governance rules (for example, the right to veto).
- Information about key company officials, members of the Supervisory Board, including their remuneration, in order to assess their experience and qualifications, the risks of conflicts of interest and the impact on their performance. Information on the procedure for selecting candidates for the Supervisory Board, their positions in supervisory boards of other entities.
- Significant risk factors that can be predicted. Measures planned or implemented to manage such risks.
- Information on any financial assistance, including government guarantees, commitments and grants, including contractual obligations arising out of public-private partnerships. Information about company relationships with creditors, key vendors and local authorities.
- Information on transactions with other state-owned enterprises involving large amounts.
- Issues related to employees and other stakeholders which can have significant impact on the results of the activity of Ukrenergo. HR policy, programs of development and personnel training, etc. Significant information on environmental, social, human rights and anti-corruption measures.

For information purposes Ukrenergo uses its corporate website www.ua.energy, as well as its official pages

⁵⁶ Order of Ukrenergo #62 from 12 February 2018.

of social networks Facebook and Twitter. Official reports of the enterprise are also distributed by its press service. Ukrenergo also discloses information involving the media and NGOs.

In October 2016, a memorandum on cooperation was signed between Ukrenergo, the National Secretariat of CoST Initiative and Transparency International Ukraine. CoST Initiative envisages disclosure of all required information regarding construction projects for verification by CoST Initiative's independent experts. For the purpose of public control over effectiveness of spending, this information is also published in open sources.

In April 2018 CoST Ukraine prepared the first in its history verification report on energy infrastructure. It evaluated the transparency and openness of Ukrenergo as unprecedented: the company provided 93% of the information on the project implementation.

Presently, the CoST Initiative program encompasses seven of Ukrenergo's projects; the scope of cooperation may be expanded in future, depending on the results of the pilot projects.

The information policy of Ukrenergo is very recent and it appears that not all information on the list is yet to be found on the website (e.g. information on remuneration of the CEO and of the Supervisory Board); Ukrenergo should comply with its policy in full as soon as possible.

4.6.7. Anti-corruption measures

Anti-Corruption Program

The current Anti-corruption Program of Ukrenergo has been in force since August 2017.⁵⁷ Its draft was developed in line with the requirements of the Law on Prevention of Corruption; it was discussed with the employees of the enterprise and approved by MECI. It is permanently accessible on the official website of Ukrenergo in the section "About Us - Combating Corruption".

Identification of internal corruption risks in the organisational, managerial, financial, economic, personnel and legal procedures of the enterprise, as well as inspection of the external corruption risks in the activities of Ukrenergo business partners, has been commissioned. The report on the results of these assessments is published on the website of Ukrenergo. The report classifies identified corruption risks by categories and types, analyses reasons for corruption risks and proposes a set of measures to prevent, eliminate or reduce the level of detected corruption risks.

Anti-Corruption Commissioner

In November 2017 Andriy Kanarskii was appointed by MECI as the Head of Division on prevention and detection of corruption and as Anti-Corruption Commissioner⁵⁸. His functions, powers and obligations are prescribed in the Anti-Corruption Programme of Ukrenergo. He reports directly to the CEO and to the ownership entity, at least on annual basis, or as required by circumstances, as well as on request by the

⁵⁷ Ukrenergo's Order #272 from 30 August 2017.

⁵⁸ Enacted by the Order of Ukrenergo #581 from 23 November 2017, which was approved by the Order of the Ministry of Energy and Coal of Ukraine #599 from 12 September 2017.

CEO or the ownership entity. He is supported in his role by the Unit on Prevention and Detection of Corruption, which he supervises.

At the same time, Ukrenergo has informed the monitoring team that it was in the process of holding a competitive selection for the position of Compliance Officer and had engaged an international consultancy firm to prepare and conduct this selection. The Compliance Officer would have been offered a competitive remuneration package which should have attracted qualified specialists, perhaps even non-nationals. Ukrenergo also intended to develop the compliance function in line with OECD requirements and international best practices. These undertakings had been supported by the IFIs, in particular the EBRD and the WB. Apparently, MECI was not in favor of launching such a competition, since this is not an express requirement by the relevant Law. Ukrenergo still managed to launch the selection process, supported by the IFIs. At the time of the drafting of this report the competition has been announced. Its results and impact on the development of the compliance function should be followed up.

Scope of application, Asset declarations and Conflict of Interest

Ukrenergo defines all of its employees as those who have the authority to carry out organizational or administrative functions. Therefore the restrictions and obligations, stipulated by the Law on Prevention of Corruption, concern all employees of Ukrenergo.

To this end, they are obliged to submit asset declarations to NACP in compliance with the provisions of Chapter VII "Financial control" of the Law on Prevention of Corruption. In 2017, out of 3993 employees who in the opinion of Ukrenergo were obliged to declare, 3917 submitted declarations. 76 persons, i.e. 1,9 % did not file the declarations. 49 of these 76 persons left their positions in Ukrenergo in the period from January 1 to April 30, 2017. NACP was properly informed about each person who did not submit a declaration.

All employees of Ukrenergo, approximately 9610 persons, provided information regarding closely related persons also employed by Ukrenergo and about the existence of any corporate rights, possibly causing conflict of interests. Reportedly it allowed to identify potential and to avoid real conflicts of interest. As a result 22 potential conflicts of interest have been resolved at an early stage in 2017.

In 2017, 111 reports on the non-submission or late submission of electronic declarations of persons authorized to perform functions of the State or local self-government in connection with the termination of labour relations were registered and referred to NACP. Detailed information, including case examples of what is being done to detect and eliminate conflicts of interest, how corruption reports are being followed up and how internal investigations are being conducted by the Unit on Prevention and Detection of Corruption have been provided to the monitoring team and illustrates that the Unit is in fact functional.

Code of Ethics

Ukrenergo's Code of Corporate Culture includes an Ethical Code. The Code regulates the activity of Ukrenergo employees inside the Company, and also applies to their interaction with business partners, customers, consumers and suppliers. The text is available online: (<https://ua.energy/about-en/personnel/code-corporate-culture/>).

Reporting of corruption and whistleblowers

To ensure timely receipt and prompt response to reported instances of corruption and other possible unlawful actions of the personnel of the enterprise, Ukrenergo established a hotline and set up a confidential email account. Alternatively, reports on corruption may be mailed to the Anticorruption Department of Ukrenergo.

It appears that reported corruption instances are being actively followed up within Ukrenergo. The enterprise has provided the monitoring team with an extract from the “database” which tracks all incoming reports and with information on what actions have been taken in regards to these reports and on the results of these actions.

A procedure for the protection of whistleblowers, and persons who provide assistance in prevention of corruption in Ukrenergo was introduced and enforced by a special order of Ukrenergo.⁵⁹ No information on whether such measures have ever been applied was provided to the monitoring team.

Anti-Corruption training

A training plan on the subject of prevention and detection of corruption for 2018 was reportedly developed and approved by Ukrenergo on the initiative of MECI but the contents of this plan have not been made clear to the monitoring team. In addition, to ensure that provisions of the Law on Prevention of Corruption are properly implemented Ukrenergo has provided employees with expert assistance and equipment for filling out the asset declarations.

Overall, it appears that anti-corruption measures within Ukrenergo are numerous and some of them have already been functioning and providing results. The establishment of a real compliance function with a Compliance Officer in charge would be a welcome development and could set the tone for other SOEs, especially unitary enterprises.

4.6.8. Procurement

Ukrenergo has developed its own policy on public procurements and since January 2017 and all procurements have been carried out in accordance with the newest standard of the enterprise – the Methodology of Managing Procurements of Goods, Works and Services as well as Conclusion of Contracts.

Ukrenergo has completely abandoned the tender committees, engaging specialists to handle procurement processes. Authorised representatives acting in the interest of Ukrenergo are responsible for the organisation of procurement procedures. The legal status, general organisational and procedural regulations, and the scope of rights, duties and responsibility of these Authorised Officers are set out in the Regulation on Ukrenergo Authorized Officers. Their names and contact information can be found on the website of Ukrenergo.

The key competences and duties of the Authorized Officers include:

⁵⁹ Ukrenergo Order #401 from 15 December 2017

- compilation and approval of annual procurement plans;
- selecting and organizing procurement procedures;
- creating equal conditions for all bidders; ensuring objective and fair selection of winners;
- publishing information and reports on public procurements;
- representing Ukrenergo on procurement matters during controlling actions, hearing of complaints, court hearings, etc.

Information about all procurements of the enterprise is fully accessible on the Trading Site integrated with Ukrenergo's official website.

Ukrenergo was one of the first companies in Ukraine to join ProZorro in April 2015 at the time of it being a pilot system. When the Law on Public Procurement entered into force in April 2016, Ukrenergo reported to be fully ready to make over-threshold procurements through the system and has decided to conduct most of its sub-threshold procurements via this system as well.

Since January 2017, purchases have been performed in accordance with the newly developed standard of the company resulting in savings of UAH 8 444 billion. A new platform, [ProZorro.Sales](#), an electronic system for auction sales of non-specialized state-owned assets, was launched in April 2017 and Ukrenergo has joined it too. Currently 90.5% of Ukrenergo's competitive under-threshold procurement procedures are conducted in the ProZorro system, which resulted in UAH 15757 million savings.

In addition, Ukrenergo implements large-scale investment projects with loans from several international financial institutions, including EBRD, EIB, IBRD and KfW. Its international tenders are reportedly held strictly in accordance with the requirements of Ukrainian law and the rigid standards of international donors.

Ukrenergo appears to be another example of announced plans for corporate governance reform in Ukraine, which are not progressing as fast as envisioned due to its unitary enterprise status which accounts for heavy regulation of – all of the processes that it needs to go through for such reform. The ownership entity is encouraged to work towards implementing good practices in the enterprise, such as the establishment of the Supervisory Board. Regulatory functions should be clearly separated from the ownership of the SOE and necessary adjustments need to be made towards this end. Corporatisation of Ukrenergo and abandoning the corporate form of unitary enterprise will be a big step forward but it should also be finalised keeping to the determined timelines.

4.7. Case-study of “Khmelnyskoblenergo”

Joint Stock Company “Khmelnyskoblenergo” (Khmelnyskoblenergo) is one of the "oblenergos" which manage electricity distribution in Ukraine. As a rule there is one distributor for each oblast (except Donetsk where there are two distributors), and Kyivenergo, which serves the city of Kyiv. Following Russia's annexation of Crimea in March 2014, two distributors, Krymenergo and Sevastopolenergo, were disconnected from the Ukrainian energy system.

Khmelnyskoblenergo is a medium sized oblenergo which manages distribution of electricity in Khmelnytsk oblast and has a much diversified base of clients, in contrast to some other oblenergos in industrial regions. Khmelnytskoblenergo owns and operates local power grids with 0.4-110 kV transmission lines, transformer substations and switching and metering equipment. It buys electricity from Energorynok for sale to end consumers as well as provides transmission services to independent power suppliers. Effectively operating as natural monopoly, Khmelnytskoblenergo, like all other oblenergos, is

strictly regulated by the NERC and operates on a “cost plus” basis, i.e. the regulator sets retail tariffs for most oblenergos based on their expected costs, grid losses and CAPEX needs.

Khmelnytskoblenenergo only receives payment for its distribution and supply services, thus earning no additional margin on the electricity volume sold. Khmelnytskoblenenergo also provides distribution services to independent power suppliers, which likewise buy electricity from Energorynok and pay it for transmitting the power to their customers. Khmelnytskoblenenergo is also responsible for payment collection and settlements with Energorynok. The sales of the company have been steadily on the rise over the past three years. The company employs approximately 3470 persons.

The State owns 70 % of the shares of Khmelnytskoblenenergo. As the result of an earlier privatisation effort there is a minority shareholder, which owns 18, 8 % of the shares whereas the remaining 11, 2 % are held by approximately 3500 shareholders, most of them private persons and households. The shares of the Company are traded at the Ukrainian exchanges. In 2015 the CoM identified Khmelnytskoblenenergo as one of the top SOEs up for privatisation. However, to date CoM has not defined any timeline for the privatisation of the Company.

4.7.1. The State as the Shareholder of Khmelnytskoblenenergo

Khmelnytskoblenenergo was originally founded by a Presidential Decree in April 1995⁶⁰ and it was corporatized into the State Joint-Stock Energy Supplying Company (SJSESC) in August 1995.⁶¹ SJSESC was formed on the premise of the State Energy Supplying Enterprise "Khmelnytskoblenenergo", which was organized on the basis of the Northern and Southern enterprises of the former PEA Vinnytsyaenergo and CHPP Kamyanyets-Podilsky electricity grids. In 1999, SJSESC "Khmelnytskoblenenergo" was transformed into a Public Joint-Stock Power Supplying Company (PJS PSC) "Khmelnytskoblenenergo". According to the Decision of the General Meeting of Shareholders on 11 November 2010, PJS PSC "Khmelnytskoblenenergo" was renamed into Public Joint-Stock Company (PJSC) "Khmelnytskoblenenergo". Finally, according to the Decision of the General Meeting of Shareholders on 26 April 2018, PJSC "Khmelnytskoblenenergo" was renamed into Joint-Stock Company (JSC) "Khmelnytskoblenenergo"

In addition to the relevant legislation Khmelnytskoblenenergo is governed by the Charter and internal Orders of the Company. The revised Charter has been adopted at the General Meeting of Shareholders on 26 April 2018. It defines the company as a legal person of the private law, which has a direct impact on the applicability of anti-corruption provisions.

The General Meeting of Shareholders should be held at least once a year. The AGM has powers as stated in the Law on Joint-Stock Companies, such as amending the Charter, emission of shares, appointing and dismissing members of the Supervisory Board and regulating their remuneration, adoption of the Annual Report and deciding on the annual dividends. Shareholders with over 10% of shares may request an extraordinary external audit and propose a candidate into the Supervisory Board.

In April 2018 the Code of Corporate Governance of Khmelnytskoblenenergo was adopted by the General Meeting of Shareholders. It defines the principles of corporate governance, the structure of the corporate

⁶⁰ Presidential Decree from 4 April, 1995 "On structural rebuilding in the electric power complex of Ukraine"

⁶¹ Order of the Ministry of Energy and Electrification of Ukraine August 17th, 1995, No. 157

management, loyalties and responsibilities, establishes an internal control system, and contains rules on disclosure and transparency. The Code follows closely the OECD Guidelines.

The exercise of ownership rights of State shares in Khmelnytskoblenenergo has been transferred from MECI to SPFU in January 23, 2012 (45% shares) and in May 08, 2013 (25% +1 share). Currently **SPFU** exercises directly and through its representatives in the Supervisory Board the corporate rights in the Company including conducting competitions to select candidates for the position of the CEO, approving and controlling the execution of the financial plan, deciding whether to write-off or sell fixed assets etc. However, **MECI** approves the plans for the development of the Khmelnytskoblenenergo's transmission grids, monitors their implementation and controls the company when it uses the State property which is under the custody of the Company but is not included in its assets.

The **CoM** approves the candidates for the position of the CEO as well as the limits of expenses for certain items of the financial plan. Should the Company earn more than UAH 50 million net profit (Khmelnytskoblenenergo is close to reaching this figure – its net profit in 2017 was over UAH 43.6 million), the CoM would take over the approval of its financial plan.

In addition, the following government bodies have the right to control the activities of the enterprise:

The State Audit Service, the State Fiscal Service and the Antimonopoly Committee have similar controlling and regulating powers as described in connection of the other case studies.

NERC approves the investment programs of the enterprise, the plans of major repairs and tariffs, according to which electricity is being sold and transferred to consumers, monitors the implementation of such programs, plans and tariffs, conducts audits in order to control the implementation of these programs and plans, and applies financial sanctions for violations.

The State Inspection of Energy Supervision of Consumption Regimes of Electric and Thermal Energy supervises the electricity consumption regimes and the technical condition and operation of electric grids, performs inspections and applies financial sanctions for violations.

The State Regional Administration approves planned tariffs and investment programs prior to the approval from NERC, without this pre-approval the enterprise cannot conduct its activities.

Interestingly, the monitoring team was told by Company representatives that the powers and functions of all these State authorities rarely overlap and therefore coordination does not appear to be a problem. However when any sort of cooperation is required, the unwillingness or inability of these authorities to cooperate with each other seriously impedes the operations and business of the Company. For example, the CEO of the Company has been selected by Nomination Committee under the SPFU 18 months ago but he is still not officially appointed due to absence of approval from CoM.

The strategic status of Khmelnytskoblenenergo puts it in danger of political and other undue influence. Reportedly the Government and other public authorities are making efforts to preserve an influence over the Company and its CEO. In the opinion of Company representatives the establishment of the Supervisory Board has helped to address this problem to some extent and the Supervisory Board is currently making efforts to minimize any such interference. The adoption of the new Corporate Governance Code, the introduction of transparency requirements and new contracts with the Supervisory Board and the CEO have also helped. These processes should therefore be continued.

4.7.2. Supervisory Board

Khmelnytskoblenergo has a Supervisory Board in line with the requirements of the Law on JSCs. The current Supervisory Board consists of seven members, including five representatives of SPFU representing the State and two representatives of the biggest minority shareholder. The State representatives also hold Government positions but they fulfil the requirements of the anti-corruption legislation. The Supervisory Board members comply with the criteria and requirements of the Law on JSCs, Law on Management of State Property and the Charter of Khmelnytskoblenergo.

Currently there are no independent members on the Supervisory Board of Khmelnytskoblenergo. In November 2017, a competitive selection for the positions of independent members of the Supervisory Board was announced with a deadline for the submission of documents in January 2018. First stage of selection took place in February 2018. The short list of candidates was formed and transferred to MEDT. In March 2018 the procedure was changed by the CoM. Taking into account that Company's Supervisory Board has wide range of duties and responsibilities, GSM did not terminate the power of the old Supervisory Board members.

Supervisory Board members will be elected by the General Meeting of Shareholders through cumulative voting. The first seven candidates who will receive the highest number of votes will be elected, with the likely result of four independent members and three representatives of Shareholders.

The Chair of the Supervisory Board is elected from among the members of the Supervisory Board. Additionally, the Supervisory Board may elect a Supervisory Board Secretary corresponding to the Company Secretary as for example in Naftogaz.

The Supervisory Board of Khmelnytskoblenergo has the same scope of duties and responsibilities as those in public joint-stock companies in Ukraine. At the initiative of SPFU the scope of duties has been extended. They are to meet no less than 4 times a year, but in practice they meet monthly. The Supervisory Board must form at a minimum two committees, the Audit Committee and the Nomination and Remuneration Committee. It is the understanding of the monitoring team that these have not yet been set up by the Supervisory Board.

Establishment of the Supervisory Board in Khmelnytskoblenergo is the right initial step to good corporate governance, however, now it would be even more important to meet the requirement of majority of independent members. The Board should also set up its Committees to ensure these functions within the Company.

4.7.3. Khmelnytskoblenergo's CEO

The CEO of Khmelnytskoblenergo is responsible for the entire operational activity, development strategy, investments and international cooperation. His powers and obligations are stipulated in the Charter of the Company. He acts on behalf of the Company and in accordance with the laws, the Charter, Company's regulations and decisions of the Supervisory Board. He is accountable to the Supervisory Board and to the General Meeting of Shareholders.

The collegial Executive Board of Khmelnytskoblenergo consists of six Deputy Directors who support the CEO in his/her functions.

Currently, the CEO of Khmelnytskoblenergo has not been appointed, Oleg Kozachuk has been appointed

to temporarily fulfil the duties of the CEO. He was appointed acting CEO with the purpose of managing the Company while the competition for the position of the CEO was on-going. However, the results of the competition, which have been submitted to the CoM for approval almost two years ago have not yet been confirmed. The Company, as well as SPFU, has reportedly received no feed-back, either positive or negative in this regard – the response is just not forthcoming.

This situation needs to be promptly addressed. The temporary status of the acting CEO exposes him to higher risks of possible political pressure, it may equally be exempting him from some of the anti-corruption obligations. Regardless of these considerations the Company needs a stable management with a long-term outlook, which cannot be ensured by the current set up. The Government needs to move forward on the decision and communicate any decision in this regard back to the Company and its Supervisory Board.

4.7.4. Remuneration

The salaries of the COE and the Directors are determined in the contracts which they conclude with the Company based on decisions by the Supervisory Board. The ceiling amounts are set by the CoM.⁶² They are calculated based on the value of assets, the annual net revenue of the enterprise and the number of personnel, multiplied by the minimum salary of an employee of the main profession in the enterprise. The calculation is made at the time of contract signing or when the decision of the Supervisory Board is made.

The salary of the Chair and the members of the Supervisory Board is determined in civil law contracts concluded with them. The decision on the completion or non-completion of those contracts, as well as the amount of their salary is being adopted by the General Meeting of Shareholders, which evaluates the report of the Supervisory Board on its activity and makes the consequent decisions. Proposals for contracts or salaries may be put forward by any Shareholder or directly by the Supervisory Board itself. The only specificity of the contractual relations with the Supervisory Board is that Government officials can enter into civil contracts with the Company to perform the duties of the Supervisory Board member but they cannot be remunerated for this.

4.7.5. Financial control

According to information provided by Khmelnytskoblenergo the Company does not have a complete and unified internal audit system. Currently only separate elements of such audit are in place. In particular, the Supervisory Board should form the Audit Committee, which would analyse the financial reporting of the enterprise on a quarterly basis. Khmelnytskoblenergo has a Control and Audit Department in its organisation, which is tasked with carrying out scheduled inspections and audits of individual units of the Company. Collaboration with external auditors is carried out if required and at their request.

Khmelnytskoblenergo annually approves and publishes financial statements of its activities. In order to be approved they must contain the report of an external auditor. External audit is therefore carried out annually in the beginning of each year. The latest audit of the financial statements by an external auditor took place in February 2018 and was done by BDO Consulting.

Khmelnytskoblenergo, being part of the State sector of economy is also inspected by the State Audit Service. These audits are done annually, as well as on ad hoc basis and are reportedly very tenuous and

⁶² CoM Resolution #859

time and resource consuming. The last audit of the Company's activities by the State Audit Service was conducted in July 2017.

4.7.6. Transparency and disclosure

Khmelnyskoblenenergo is obliged to publish information about its activities in line with the requirements of the Law on JSCs including financial reports, basic documents regulating its activities, the outline of the corporate governance structure and information on significant transactions. Failure to comply with the disclosure requirements can entail financial sanctions, this ensures that the requirements are strictly abided.

Additionally, the Supervisory Board of Khmelnyskoblenenergo has decided that the Company shall voluntarily publish the following information:

- Annual financial statements;
- Quarterly statements;
- Key economic and technical indicators;
- Audit reports;
- Investment programs;
- Company's Charter, collective agreement, Corporate Ethics Code, decisions of General Meetings.

Financial statements are disclosed annually, quarterly information - quarterly, information on the outline of the corporate governance structure and significant transactions - immediately after the relevant event, information on the decisions of the supervisory board and the executive body - within 30 days from the date of their adoption.

Financial statements, quarterly information, the outline of the corporate governance structure, and information on significant transactions are disclosed by posting on the official website, publication in media and submitted to the National Securities and Stock Market Commission. All other information is disclosed by posting on the official website.

For information purposes Khmelnyskoblenenergo uses its own resources, corporate websites www.hoe.com as well as its official pages of social network Facebook. Official reports of the Company are also distributed by the press service. The Company also discloses information involving the media and NGOs.

Information concerning CEO's salary is submitted on a quarterly basis to the SPFU and MEDT which maintains a register of the Heads of legal entities of the State sector of the economy. This information is made public through annual reports.

Information on the decisions of the Supervisory Board and the Executive Board of the enterprise is disclosed exclusively to the Shareholders, which have a separate log-in portal with password within the website and have access to a much broader range of information.

4.7.7. Anti-corruption measures

Anti-Corruption Programme and Commissioner

The Anti-Corruption Programme of Khmelnytskoblenergo was approved in April 2015⁶³ and is available on the Company's website. The Anti-Corruption Programme was developed by the Business Security Service, monitoring of its implementation is vested with the Anti-Corruption Commissioner. Employee of the Company was appointed to this position by the CEO in 2015. In February 2017 Khmelnytskoblenergo adopted its Corporate Ethics Code.

Scope of application, Asset declarations and Conflict of Interest

The monitoring team was informed that in the opinion of the Company neither its managers nor its employees are considered to be public officials, except for the members of the Supervisory Board who are representatives of the State Shareholder. At the website of Khmelnytskoblenergo there are instructions which refer employees of the Company to the NACP explanatory note and inform them about the deadlines for the submission of declarations. It is however unclear if anybody submits asset declarations in addition to the above-mentioned members of the Supervisory Board, and which employees are covered by the conflict of interest rules.

Reporting of Corruption and whistleblowers

Khmelnytskoblenergo established the following channels for reporting of corruption:

- Personal meetings with the CEO, held once a month, where it is possible to discuss any issues with the CEO, including alerting him to instances of corruption;
- Written complaints, including anonymous. Khmelnytskoblenergo has a system which follows up on these complaints.⁶⁴ They are reviewed by the Business Security Service, and in case corruption is detected, they are transferred to the Anti-Corruption Commissioner. Complaints can be submitted to a Registry and deposited in specially designated boxes located in each subdivision to be handed directly to the personnel of the Business Security Service or the Anti-Corruption Commissioner. Apparently the CEO is notified on a weekly basis on the status of verification and processing of these complaints. However it is the understanding of the monitoring team that such complaints may cover all areas and operations and are thus not corruption specific.
- Hotline number that is connected to the Business Security Service. Any person can leave a message, including reporting of corruption. The number of the Anti-Corruption Commissioner is also made known for corruption-specific reports.

Protection measures afforded to whistleblowers are maintaining confidentiality of the information and not allowing reprisals at work.

The results that these measures have yielded in the area of anti-corruption are not substantial. Only one instance of corruption has been detected since 2015. Khmelnytskoblenergo has also identified 17 cases of conflict of interest and resolved all of them.

⁶³ Order of the CEO #336 from 30 April 2015

⁶⁴ The CEO of Khmelnytskoblenergo explained that there is a database in which each complaint is entered and the status of its review is entered with each steps of the review and can be monitored by the Anti-Corruption Commissioner and the CEO.

Anti-Corruption training

Khmelnytskoblenergo has its own training centre where its employees undergo regular training. Training for Heads of Departments and services are conducted on annual basis and include an anti-corruption component. The rest of the educational efforts are done through posting of relevant information on the website of the Company.

4.7.8. Procurement

Khmelnytskoblenergo is using ProZorro system for purchases of goods and services above the required thresholds since 2016.

For procurement outside of this system the Company is putting together a Tender Committee which consists of eight persons, who organise and conduct tenders. The Tender Committee is supported by the Logistics Department which collects the needs of the business divisions, consolidates them, evaluates financial opportunities and transfers the procurement plan for implementation by the Tender Committee. After conducting tenders and concluding contracts, the Logistics Department organizes the storage and distribution of the purchased goods.

The following procurement-related information of Khmelnytskoblenergo is available on its website:

- Annual plan, appendix to the annual plan and changes to it.
- Tender documentation and changes to tender documents and explanations of these changes.
- Protocol of consideration of tender offers.
- Notice of intention to conclude a procurement contract.
- Information on the rejection of the tender offer of the participant.
- Procurement contract.
- Notification of amendments to the contract.
- Report on performance of the contract.
- Report on concluded contracts.

Khmelnytskoblenergo contributes to the previously expressed impression that the Government does not have a clear vision as to where it is going in regards to its SOEs. Reforms are being announced and then left pending. In the case of Khmelnytskoblenergo it appears that its management is operating under many uncertainties, its status is not confirmed, the Supervisory Board independent members are not yet appointed and most importantly since the announcement in 2015 of the eventual privatization, the Company is still not clearly informed on when this would happen and what form of privatization is going to be pursued. The obligatory dividend rate applied to all SOEs continues to have no regard to the profitability and financial position of the companies. In Khmelnytskoblenergo which has other shareholders this issue becomes even more acute and requires prompt attention and resolution.

4.8. Case-study of “Turboatom”

Joint Stock Company JSC “Turboatom” (Turboatom) produces turbine equipment for thermal, nuclear and hydroelectric power generating plants, supplying to over 10% of the world’s nuclear power generating capacity, which makes it the world’s fourth largest turbine producer. In Ukraine, the Company’s turbines operate in 40% of thermal power plants, 85% of nuclear power plants and 95% of hydro power plants. The Company has supplied its produce to 45 countries globally. Its major competitors are Russian Power Machines, Siemens, Alstom, ABB and Shanghai Electric.

Turboatom is an export-oriented company, relying on foreign markets for around 50 % of its revenue. Turbines and other equipment for nuclear, hydro and thermal power plants have been supplied to customers in Ukraine, Russia, Kazakhstan, Georgia, Tajikistan, Hungary, Bulgaria, India and Mexico.

Machine building is the fifth largest sector in Ukrainian economy and Turboatom is one of the three SOEs, in addition to Antonov and Pivdenmash, which account for over 50% of this sector's total revenues. It is also the eighth largest SOE based on the net income indicator.⁶⁵ The sales of Turboatom over 2015 – 2017 have been at the fairly steady level, however the profits have been going down and this can be attributed to the cyclical nature of business of the company. The Company accounts for 0.2% of GDP of Ukraine in 2015 and 0.12% in 2016 and employs over 3 500 persons.

4.8.1. The State as the Shareholder of Turboatom

Turboatom was initially established in November 1994 as JSC by a Presidential Decree⁶⁶ and in January 1996, pursuant to an Order of SPFU⁶⁷, it was transformed from the unitary enterprise "Scientific and Production Association "Turboatom" into a public joint stock company. Turboatom was partly privatized in 1996. Currently the part of the State in the authorized capital of the Company is 75.2 %. Other significant shareholders are Svarog Asset Management, an investment company with Ukrainian ownership which holds 15.3 % of the shares and Biscione Ltd, a Cyprus entity with Russian ownership holding 5.6 % of the shares.⁶⁸ The shares of Turboatom are traded at the Ukrainian exchanges and the total number of shareholders is over 7000, many of them are current or former employees.

In addition to the relevant legislation, Turboatom is governed by the Charter and the internal Orders of the Company. A revised Charter has been adopted at the General Meeting of Shareholders on 18 April 2018. It defines the Company as a legal person of the private law.

In April 2018 Turboatom adopted a Corporate Governance Code by a decision of the General Meeting of Shareholders. The Code defines the principles of corporate governance, the structure of the corporate management and loyalties and responsibilities, it establishes the internal control system, and contains rulings on disclosure and transparency. The instructions of the Code regarding corporate governance closely follow the OECD Guidelines.

Exercise of the State's corporate rights is carried out by the **SPFU**. The State exercises its shareholder rights in accordance with the Law on JSCs and in line with the restrictions provided by the Law on Management of State Property. The **CoM** approves Turboatom's financial plans. The **CoM** also plays a role in the selection of Turboatom's CEO.

In addition, the following State authorities exercise control over the operations of Turboatom:

- **National Securities and Stock Market Commission:** The Company discloses on the stock market regularly (quarterly, annually) information, as required by the legislation of Ukraine.

⁶⁵ According to the information from TOP 100 SOEs in the first 6 months of 2017.

⁶⁶ President Decree #699/94 "On measures to ensure rights of citizens to use privatization property certificates" from 26 November, 1994

⁶⁷ SPFU Order # 16-AT from 31 January 1996

⁶⁸ SPFU, Privatisation 2018 presentation for investors.

- **State Audit Service of Ukraine of Kharkiv region** conducts financial audit of the economic operations of Turboatom with the view of ensuring protection of the interests of the State and avoiding unjustified losses. This function, as in all other companies reviewed in this report, is imbedded in the Turboatom's organisation and structure and is performed on a daily basis by persons who have been delegated by the SAS to work at the premises of the Company.
- **Kharkiv division of the Office of Large Taxpayers of State Fiscal Service** monitors the reporting of taxes, as well as their timely payment as required by law.

4.8.2. Supervisory Board

Turboatom has a functioning Supervisory Board. Its duties are defined by the Charter of Turboatom and its work is regulated by the Law on JSCs, the Charter and the Regulation On the Principles of Establishment of the Supervisory Board.

Decisions on the appointment and dismissal of the members of the Supervisory Board are taken by the General Meeting of Shareholders. Members of the Supervisory Board are elected by cumulative voting. Members of the Supervisory Board elected as representatives of a certain Shareholder may be replaced by this Shareholder by simply notifying the Company.

The rights, duties and responsibilities of the members of the Supervisory Board are the same for all types of JSCs, regardless of their ownership form. At the initiative of SPFU the scope of duties has been extended. The fiduciary duties of the members of the Supervisory Board are similar to those of the private sector, as the Law on JSCs provides that members of the Supervisory Board protect the rights of shareholders and act in the best interest of the Company.

The General Meeting of Shareholders is planned to adopt a Regulation on the remuneration of members of the Supervisory Board. Turboatom representatives reported that such a regulation has been drafted. However, the planned regulation must meet also the requirements set by the National Securities and Stock Market Commission, which has not yet published such requirements.

The current Supervisory Board of Turboatom consists of five persons, four of which are representatives of the State shareholder, the SPFU:

- Parfenenko Dmitry Nikolayevich – Supervisory Board Chairman, representative of the SPFU;
- Astashev Evgeny Viktorovich – Supervisory Board Deputy Chairman, representative of the SPFU;
- Vizir Aleksandr Sergeyeovich - member of the Supervisory Board, representative of the SPFU;
- Denisenko Vitaliy Nikolayevich - member of the Supervisory Board, representative of the SPFU
- Umanskaya Elena Petrovna - member of the Supervisory Board, representative of the Shareholder, “Svarog Asset Management” LLC.

SPFU has initiated the selection of three independent members for the Company's Supervisory Board. In November 2017, a competitive selection for the positions of independent members of the Supervisory Board was announced with a deadline for the submission of documents in January 2018. First stage of selection took place in March 2018. The short list of candidates was formed and transferred to MEDT. However the CoM changed the procedure while the selection process was underway. Taking into account that TA's Supervisory Board has wide range of duties and responsibilities, GSM of the Company did not terminate power of the old Supervisory Board members.

Ukrainian law and best practices require that a Supervisory Board is comprised of a majority of independent members. It is of utmost importance that current selection for such members for Turboatom is finalised and these members are appointed into the Supervisory Board. Once the Supervisory Board of Turboatom is fully staffed, its Audit Committee should be established and replace the Counting Commission, again to meet the requirements of Ukrainian law, as well as to comply with international good practices. A Nomination and Remuneration Committee would also need to be established.

According to the answers to the questionnaire and the representatives of Turboatom met at the on-site visit, the present Supervisory Board effectively manages to insulate the Company from any improper political or other interferences into its operations and other activities.

4.8.3. Turboatom's CEO

The CEO of Turboatom is responsible for the entire operational activity, development strategy, investments and international cooperation. His powers and obligations are stipulated in the Charter of the Company. He acts on behalf of the Company and in accordance with the laws, the Charter, the Company's regulations and decisions of the Supervisory Board. He is appointed and his duties are terminated by decisions of the Supervisory Board. His candidacy is confirmed following the CoM procedure by the Committee on Appointments operating under CoM. He is accountable to the Supervisory Board and to the General Meeting of Shareholders.

The collegial Executive Board of Turboatom consists of the CEO and ten Deputy Directors who are appointed by the Supervisory Board upon proposals from the CEO and who support the CEO in his/her functions.

Viktor Subbotin was elected by the General Meeting of Shareholders on 22 April 2007 as the General Director of the Company under the Charter then in force and reelected in April 2015.

4.8.4. Remuneration

The Company independently determines the salary fund and establishes the forms, systems and fund of labor remuneration of its employees, as well as the procedure of submission and duration of the annual paid leave in line with the requirements of Ukrainian legislation.

The salary of the CEO and the Directors of Turboatom is paid according to the concluded contracts. The Supervisory Board approves the form and terms of the contract with the CEO and members of the Executive Board. It is also planned to adopt a regulation on the remuneration of the CEO and members of the Directorate.

A regulation on the remuneration of the Supervisory Board is also pending, as explained earlier and will need the National Securities and the Stock Market Commission's decision in regards to requirements for such regulations.

4.8.5. Financial control

The annual financial statements of Turboatom are audited by external independent auditors and State authorities. The latest external audit of the financial statements was made by the LLC "Ernst and Young Audit Services" on 31 December 2016. Currently, the financial statements as of 31 December 2017 are being audited by the same audit firm.

An extraordinary external audit can also be performed at the request of a Shareholder of the Company, holding more than 10 % of the voting shares. In such a case this Shareholder will independently conclude the contract for the audit, indicating the scope of the audit, and will incur the costs of such an audit. This has not happened yet.

According to the newly adopted Charter of Turboatom, the internal audit of the enterprise reports to the management and the Supervisory Board of the Company. The internal audit service is subordinate to the Supervisory Board, its personnel is appointed and the terms of the contracts with it are coordinated by the Supervisory Board. However, it is the understanding of the monitoring team that this shall be the situation once the Audit Committee of the Supervisory Board is established. Currently functions of internal audit are conducted by the Internal Audit Service of Turboatom. According to the answers to the questionnaire, the Internal Audit Service of the Company is subordinate to the supervisory board.

Representatives of the State Audit Service of Ukraine of the Kharkiv region carry out regular audit and inspections of Turboatom. Again, like in all companies that the monitoring team met, this is done on a continuous basis, requiring heavy resources. Some of the conclusions of the State Audit Service have been contested by Turboatom in courts with positive outcomes – this however also requires investment of time and resources.

4.8.6. Transparency and disclosure

Turboatom is obliged to publish information about its operations and activities in line with the requirements of the Law on JSCs, including financial reports, basic regulations regarding the activities, the outline of the corporate governance structure and information on significant transactions. Failure to comply with the disclosure requirements can entail financial sanctions, this ensures that requirements are strictly abided.

Disclosure of financial and non-financial information is carried out by the Company on its own website www.turboatom.com.ua and in the public database of the National Securities and Stock Market Commission on the website www.stockmarket.gov.ua. It is also published in the official printed edition of the report by the National Securities and the Stock Market Commission.

The following information is currently disclosed on the Company's website:

- Annual financial statements;
- Quarterly statements;
- Key economic and technical indicators;
- Audit reports;
- Investment programs;
- Company's Charter, collective agreement, Corporate Ethics Code, decisions of General Meetings.
- Anti-Corruption Programme.

The above-mentioned information is posted on the Company's website within thirty days from the date of its receipt by the Company, if a shorter period is not stipulated by the legislation.

Turboatom reports and discloses more information than what is required by law. In particular, information on the composition of the Supervisory Board and the remuneration of the members is disclosed on its website.

Information on the decisions of the Supervisory Board and the Executive Board of the enterprise is disclosed exclusively to the Shareholders, which have a separate log-in portal with password within the website and have access to a much broader range of information.

4.8.7. Anti-corruption measures

Anti-Corruption Programme and Commissioner

Turboatom has adopted the Anti-Corruption Programme and Anti-Corruption Policy in 2015 and new Anti-Corruption policy document was adopted in 2018 following the requirements of the Law on Prevention of Corruption. They follow closely the template programme recommended by NACP. Their implementation is controlled by the Anti-Corruption Commissioner (Compliance Lawyer). He reports to the CEO and to the General Meeting of Shareholders. The Legal Director of Turboatom was appointed to this position, as Turboatom's management believed he matched the necessary qualifications best.

When implementing anti-corruption strategic regulations Turboatom required all employees to sign a memorandum on measures aimed at preventing corruption. Newly recruited employees also reportedly get acquainted with the basics of combating corruption inside the Enterprise, including signing relevant memoranda about it. Amendments have been made to the existing internal labour rules and regulations, which stipulate a disciplinary liability for non-compliance with the Anti-Corruption Program. Anti-Corruption clauses have been introduced in all contracts concluded by Turboatom.

Scope of application, Asset declarations and Conflict of Interest

The monitoring team was informed that in the opinion of the Company none of its employees, including the management, fall under the definition of Public Officials, except the members of the Supervisory Board being representatives of the State. To this end, the Company has sought outside legal counsel in this regard. Five legal expert opinions have been issued on this matter stating that the requirements of the Law on Prevention of Corruption do not apply to the employees of Turboatom. Representatives of the Company met at the on-site visit informed the monitoring team that they have requested also the NACP's opinion. When the legal opinions were available, a meeting was organised with the NACP Commissioner where he reportedly accepted Turboatom's position. Therefore, no asset declarations have been submitted by or on behalf of Turboatom's employees.

Reporting of Corruption and whistleblowers

Reports on corruption can be sent via Turboatom's email, made over the phone to the Anti-Corruption Commissioner or in a personal meeting with him.

Reports can be made anonymously. Any data that make it possible to identify the applicant will become confidential information. The Anti-Corruption Commissioner and other persons involved in the inspections are not entitled to disclose such information, except in cases provided for by the Law or by the voluntary consent of the applicant.

In addition, any person who reports corruption cannot be dismissed or forced to resign or brought to disciplinary responsibility. Also no other negative measures can be applied to him for reporting of alleged facts of corruption, such as transfer, re-attestation, changing working conditions, refusal to appoint to a higher position, reducing remuneration, etc. In case of unauthorized leakage of information about such a

person, the Head of the enterprise should immediately take measures in order to eliminate possible negative consequences for the whistleblower.

In case of threat to the life, health or property of a whistleblower, or his close relatives, in connection with the reporting of a violation of the anti-corruption legislation, the whistleblower may:

- report such facts to the Anti-Corruption Commissioner for further referral to law enforcement authorities;
- independently inform law enforcement authorities for the adoption of measures provided by the current legislation of Ukraine.

No instances of corruption have been reported according to Turboatom since 2015.

Anti-Corruption training

Turboatom reportedly provides anti-corruption training to its employees and undertakes various awareness raising measures. All these seminars have been organised either with the involvement of external expertise or internally. No assistance in this regard has been received from NACP.

Turboatom is one of the companies in regards to which numerous reforms have been announced. All of this is forthcoming very slowly. Efforts of the State in this regard need to be clearly stepped up. In particular, independent members of the Supervisory Board should be selected and appointed, and the Supervisory Board should start operating in accordance with international good practices and OECD Guidelines. The obligatory dividend rate applied to all SOEs continues to have no regard to the profitability and financial position of the companies. In Turboatom which has other shareholders this issue becomes even more acute and requires prompt attention and resolution.

Recommendation 17

1. 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.
2. 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.

Recommendation 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.

www.oecd.org/corruption/acn/

