



UKRAINE

TECHNICAL ASSISTANCE REPORT—REFORMING MANAGEMENT AND OVERSIGHT OF STATE ASSETS

February 2016

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Reforming Management and Oversight of State Assets

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ACRONYMS AND ABBREVIATIONS

ACU	Accounting Chamber of Ukraine
AFS	Annual Financial Statements
AMCU	Antimonopoly Committee of Ukraine
BCU	Budget Code of Ukraine 2011
CCU	Commercial Code of Ukraine
CIS	Commonwealth of Independent States
CoM	Council of Ministers
EU	European Union
FAD	Fiscal Affairs Department
Fininpro	Financing for Infrastructure Project
GDP	Gross Domestic Product
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
LM	Line Ministry
MEFP	Memorandum of Economic and Financial Policies
MoE	Ministry of Economic Development and Trade
MoF	Ministry of Finance
NAS	National Accounting Standards
NBU	National Bank of Ukraine
OECD	Organization for Economic Cooperation and Development
PFM	Public Financial Management
SAI	Supreme Audit Institution
SFI	State Financial Inspectorate
SLSU	State Land Agency of Ukraine
SOE	State-Owned Enterprise
SPF	State Property Fund
STU	State Treasury of Ukraine
TA	Technical Assistance
TSA	Treasury Single Account
UAH	Ukrainian Hyrvnia
VR	Verkhovna Rada (Parliament of Ukraine)

PREFACE

At the request of the Ukrainian Ministries of Economy and of Finance, a technical assistance mission visited Kiev during January 27–February 11, 2015. The purpose of the mission was to advise the authorities on finalization of their reform strategy for state-owned enterprises (SOE). The mission met with Mr. Abromavicius, Minister of Economic Trade and Development; Mr. Pivovarsky, Minister for Infrastructure; Mr. Kachur, Deputy Minister of Economic Trade and Development; Mr. Fudashkin and Mr. Lisovenko both Deputy Ministers of Finance; Mr. Kava, Deputy Minister for Infrastructure; Mr. Yarememko, Deputy Chairman of the Accounting Chamber of Ukraine; Mr. Barash, Chairman of the Antimonopoly Committee and their senior staff. The mission also met with senior officials from the Ministry of Agriculture, the Presidential Administration, the Council of Ministers and the State Inspection Service. In addition, the mission met with senior management of a number of State-Owned Enterprises including Naftogaz, Antanov, Fininpro, Ukrecoresources, UKR Hydroenergo, and UKR Railways as well as representatives of the business community including audit and investment banking representatives. In addition, the mission met with representatives of the World Bank and the European Commission.

The mission would like to express its sincere appreciation for the excellent support given by all these staff during the mission. The mission is also extremely grateful for the excellent support given to the team by staff at the IMF office, in particular, to Mr. Shpak for his truly excellent support, and to Ms. Burliai, Ms. Semenenko, and Ms. Shulga for their excellent interpretation and translation efforts over the course of the mission.

EXECUTIVE SUMMARY

Reform of the SOE sector is a high priority for the government. The recently published “National Strategy 2020” promises “state property management reform,” and related reforms in areas such as the organization of government agencies, public procurement, competition policy, and corporate regulation. Reform of the SOE sector also features prominently in the government’s 2014 Coalition Agreement.

High levels of direct and indirect state support is adding to the significant fiscal risks emanating from SOE sector, a problem that is being exacerbated by the severe economic situation. In addition, weaknesses in the management of the state’s investment portfolio need to be addressed to help to significantly increase the value of the government’s portfolio of state assets. This will only be possible through improved oversight and governance of the SOE sector.

Improving governance arrangements

The various roles that government plays vis-à-vis the SOE sector are fragmented across a variety of institutions, with frequent overlap and conflicts of interest undermining effective oversight. Government simultaneously acts as shareholder, financier, regulator, supervisor, customer, and supplier. The same institutions are involved in developing sector policy, appointing management, reviewing/approving company plans, and evaluating performance. The result is a multiplication of structures of oversight, with overlapping and internally conflicting roles. Improving the external governance of SOEs can’t be achieved without tackling institutional challenges.

SOEs have not operated in a well-regulated environment in the past resulting in competitive distortions and the lack of effective market oversight. The current reforms should seek to enforce existing competition rules and ensure that the appropriate regulatory controls are in place to reduce instances of monopolistic behaviors, especially by SOEs and promote competition and market efficiency.

There is a need to establish proper corporate governance arrangements through improving performance management frameworks and making SOEs accountable for poor performance, reinforcing financial and fiscal discipline. This should also lead to improvements in tax collection and more clarity on the level of dividend remittance to be expected from the sector.

Establishing independent Boards of Directors to perform stewardship and oversight function for public sector entities and improving transparency and reporting to the parliament and the general public should form the cornerstone of the reform strategy for all SOEs.

Fiscal Risk Management

Capacity to assess fiscal risks emanating from SOEs is weak. While some analysis of the impact of adverse shocks is carried out, no one is currently tasked with identification or assessment of fiscal risk or their potential budgetary impact.

Unanticipated impacts on the budget from SOEs can come from a wide range of sources, including: adverse macroeconomic shocks; lack of information on the underlying financial position of SOEs; possible future recapitalization or increase subsidy requirements from loss making SOEs and government guarantees.

Public disclosure of fiscal risks can help manage budget vulnerabilities more effectively, improve economic efficiency, and lower debt service costs. Identification of fiscal risks is critical to raising awareness. Assessing the scale of fiscal risks will require a scaling up of analytical capacity and the preparation of statements of fiscal risks, initially for the SOE sector but this should quickly be expanded to include a more general statement of fiscal risks to be included with budget documentation.

Once fiscal risks have been identified and reported, actions to mitigate these risks should be considered. These could include (i) aligning wages, tax and benefits for non-market public corporations currently classified outside of the general government with the rest of the public administration; (ii) creation of budget contingencies; (iii) gradually phasing out subsidies, adjusting pricing policies to cost recovery levels and making the remaining subsidized component explicit in the budget; (iv) strengthening governance arrangements surrounding SOE borrowing; and (v) disclosing and capping budget indirect subsidies and tax expenditures.

Conceptual strategy to reform State Asset Management

Previous attempts to introduce reforms to address underperformance and sub-optimal oversight arrangements of the portfolio of state assets have not been successful, for a variety of reasons. These included the absence of a consolidated professional ownership entity; lack of transparency, inadequate governance arrangements; and incomplete information on size and complexity of the portfolio.

The latest initiative to reform the management of state assets has, at first glance, a greater chance of success. A draft concept note being prepared by the Ministry of Economy to feed into a broader reform strategy includes proposals to address the lack of transparency, separate the State's ownership and regulatory functions, introduce a value maximization objective for the portfolio, and creation of analytical capacity to oversee the State's interests.

However, the concept note and subsequent reform strategy would benefit from further elaboration. Areas to consider include the need for a full inventory of SOEs and other state-owned assets including real estate. Real estate is a source of considerable value that had not been tapped by the government, to date. In addition, the complexity and fragmentation of legal

framework would warrant a review of the existing legislation surrounding management of state assets to ensure that the reform effort is legally supported.

SOEs commercial objectives should be separated from activities carried out to implement the government's fiscal policy objectives, while agencies performing government functions should not be included in any plans for a new portfolio based approach to state asset management. The role of existing institutions surrounding management and oversight of state assets, including privatization and market regulation should also be reviewed and rationalized with a view developing an institutional structure that is fit for purpose.

Historically, privatization efforts have not proven to be very successful. Privatization regulations should be simplified and aimed at creating a level-playing field to allow the State to obtain the best price and/or most advantageous investments conditions. Further attention should be given to the governance of the privatization process itself, to ensure that it is carried out in a transparent and accountable manner that maximizes value for the state.

To inform the debate at government level, a clearer view of the different options to be considered for developing an ownership and management structure for the portfolio should be provided, as outlined in the report. There should also be a recognition of the need for strong political buy-in and a broad based communication strategy to ensure that the legislature and the general public is fully informed about the reform strategy and the expected benefits that the reforms will be expected to bring to the economy.

Table 1 is a list of summary recommendations and proposals for follow up technical assistance to help implement the PFM reforms being proposed in the report.

Table 1. Ukraine: Summary of Recommendation and Action Plan

Rec No.	Action	Short-term	Medium-Term
Improving Governance Arrangements			
2.1	<i>Develop a single reporting framework under the responsibility of one institution</i>		
2.2	<i>Amend the Law on State Secrets to enhance transparency and governance</i>		
2.3	<i>Improve transparency by implementing web-based reporting</i>		
2.4	<i>Implement a capacity building plan at all levels of institutional framework</i>		
2.5	<i>Restructure the Antimonopoly Committee to ensure that it is fit for purpose</i>		
2.6	<i>Define clear criteria for the creation and disbanding of SOEs</i>		
2.7	<i>Enhance the role of the parliament in the SOE governance framework</i>		
2.8	<i>Eliminate the dual approach to the SOE corporate governance framework</i>		
2.9	<i>Reform performance management system to evaluate on a standardized basis</i>		
Fiscal Risk Management			
3.1	<i>Strengthen safeguards to provide state guarantees on SOE loans</i>		
3.2	<i>Prepare a fiscal risk assessment for SOE sector</i>		
3.3	<i>Prepare comprehensive fiscal risk statement to be included in budget documentation</i>		
3.4	<i>Review the rationale for the existence of SOEs in areas where a private market exists</i>		
3.5	<i>Strengthen capacity in economic ministries to identify and assess fiscal risks</i>		
3.6	<i>Strengthen databases to include information on the public sector balance sheet</i>		
Strategy for Management and Oversight of State Assets			
4.1	<i>Further develop the draft SOE reform concept note</i>		
4.2	<i>Include in the concept note a description of the key challenges to be addressed</i>		
4.3	<i>Expand the coverage of information collected by the MOE to include all state assets</i>		
4.4	<i>Review how legal title of assets owned by the state can be assigned to SOEs</i>		
4.5	<i>Review the role of the SPF in managing the privatisation process</i>		

I. INTRODUCTION

- 1. The public sector has a critical role in the Ukrainian economy.** The general government controls a large quantity of economic assets, both directly (about half of the real estate property is in public hands¹ and public expenditure accounts for about half of GDP) and through public enterprises with assets estimated at more than 60 percent of GDP.² These can take different forms, including government-owned independent ordinary companies and other agencies similar to government departments, and public-private ownership joint-stock companies.
- 2. The functions carried out by the State-Owned Enterprises (SOE) range from the provision of basic public services, including in the social domain, to utilities services and infrastructure.** Several companies are active in the manufacturing sector (for example, aircraft manufacturing and petrochemical industry), energy generation and distribution, transportation and logistics infrastructure, IT industry, and military sector. While the size of the public sector, including general government and SOEs, is large with combined revenue above 70 percent of GDP, SOE governance and oversight are fragmented and the legal framework is not harmonized (see Chapters II and IV).
- 3. Public assets constitute the largest share of the business sector in the economy.** There were more than one million real estate plots in the hands of the general government alone and 1,833 active entities operating as of end-2014 (out of 3,350 registered public enterprises), based on the SPF data and the Ministry of Economy and Trade (MoE) data (Table 2). Total revenue accrued by the sector was high at about 20 percent of GDP, of which about one quarter was generated by the energy company Naftogaz. These entities employed more than 1 million people (about 25 percent of the general government staff). The bulk of assets managed by SOEs are in the energy and coal sectors (about 60 percent of total assets managed by public enterprises) and infrastructure (about 15 percent of total assets). The distribution of SOEs is heavily skewed, with the top 50 public enterprises accounting for more than 80 percent of total revenue and a similarly high share of assets. More than half of SOEs have low revenue streams, below USD 1 million per year.

¹Total land is about 60 million hectares in Ukraine, of this state-owned land is about 47 percent and the rest is owned by the private sector and, to a lesser extent, by subnational governments. About 17 percent of the land is covered by forestry and agricultural land owned by state is about 10 million hectares.

² Source: MOE.

Table 2. Ukraine: Net Financial Losses of Top Loss-Making Public Enterprises

Year	2012	2013	2014 ¹
Number of companies	3,622	3,632	3,350
Active companies	2,255	2,109	1,833
Average monthly wage (UAH)	3,911	4,202	2,801
Wage arrears (UAH thousands)	479.1	259.2	656.1
Assets (UAH billion)	758.3	789.0	869.9
Net financial losses (UAH millions)	11,890	17,839	79,872
Employees (thousands)	1,164	1,112	952
Losses by employee (UAH)	10,215	16,042	83,899

Sources: MoE data; IMF staff estimates.

1/ Figures for 2014 based on cumulative data for the first three quarters of the year.

4. **The SOE sector has large direct and indirect costs for taxpayers.** Budget subsidies directed at SOEs for mandated programs and cost-recovery purposes are estimated by the Ministry of Finance (MoF) at almost 2.5 percent of GDP in 2014. This is mostly related to the energy and coal sectors, as well as programs to build infrastructure and public services. In addition, indirect subsidies not accounted in the budget were as high as 6 percent of GDP, mostly reflecting government recapitalization of the loss-making energy company Naftogaz. The SOE sector's financial losses are estimated to have reached 5 percent of GDP in 2014 (including Naftogaz; and 1 percent of GDP excluding it) on the basis of information compiled by the Ministry of Economic Development and Trade (MoE) on the largest public companies.³ Dividends from profit-making SOEs to the budget have been declining over time and are estimated to have reached about 0.2 percent of GDP. Only 64 percent of the active SOEs had reported profits in the first three quarters of 2014, with the remaining public enterprises either reporting losses or a break-even financial result.

5. **There is limited information and transparency about public commercial assets.** Consolidated reports of public assets, its value, yield, and financial performance are not available. Even estimates about total number of SOEs or the number of real estate plots are uncertain and in the public domain. Financial data relating to capital structure and financial results, including losses impacting the budget, are not available to the Verkhovna Rada and the public at large. Scrutiny of value, yield, and financial performance of public commercial assets and its implications for public finances is severely hampered by the lack of timely and consistent information. Data provided by the statistical service of the MoE do not cover public assets and different data providers in the country have diverging takes on basic information, such as the number of operating SOEs.⁴

³ Losses amounted to about UAH 80 billion including Naftogaz and UAH 11 billion excluding it, in the third three quarters of 2014, based on information provided by the MoE.

⁴ For example, the State Property Fund counted 4,500 SOEs in 2014 of which, a significant proportion were either in liquidation or were not operating at the time of the estimate.

6. **Reflecting the heterogeneous features of public commercial assets, fiscal oversight is the responsibility of different agencies.** While the MoE has a key role envisioned in the legislative framework to provide aggregate information of the sector, and the MoF has responsibility on financial activities of SOEs which have a direct linkage with the budget, operational decisions are made frequently by sectoral ministries. These decisions concern both the regulatory and policy dimensions, as well as operational and managerial decisions with respect to the assets directly supervised by each line ministry.

7. **The importance of the public commercial assets and the existing weaknesses in management and oversight of the sector would suggest that urgent reforms are warranted.** To this end, the following sections of the report seek to analyze the fiscal risks emanating from the sector and how to mitigate them; advise on a future reform strategy for the sector as a whole; and identify areas to be strengthened in terms of governance arrangements.

II. IMPROVING GOVERNANCE ARRANGEMENTS

A. Background

8. **Improvement in the corporate governance of the SOE sector are a pivotal component of reform in addressing Ukraine's underlying macro-fiscal vulnerabilities.** Influence of line ministries, weak or absent corporate structure including components such as boards of directors, lack of transparency and inconsistent performance monitoring have contributed to weak performance and acted as a contributing factor to fiscal imbalances.⁵ Improvements in levels of corporate governance in the SOE sector should help to generate positive spillovers for Ukraine's competitive environment, efficiency of public service provision, and allocative efficiency of public finances.

9. **The draft concept note identifies the OECD's guidelines on corporate governance of SOEs as the benchmark in seeking to strengthen governance arrangements.**⁶ This is to be welcomed. The rest of this section analyses the changes required to strengthen governance arrangements with a specific focus on the State ownership function, performance monitoring, financial and fiscal discipline, Board of Directors and transparency, reporting and disclosure.

B. The State Ownership Function

10. **While the Constitution, Commercial Code of Ukraine (CCU) and the State Property Law vest responsibility for oversight of SOEs to the Council of Ministers (CoM), in reality**

⁵ "Ukraine System of Financial Oversight and Governance of State Assets," World Bank, 2011.

⁶ For more information, see <http://www.oecd.org/corporate/ca/revisionoftheoecdguidelinesoncorporategovernanceofstate-ownedenterprises.htm>

ownership is fragmented and scattered amongst a myriad of stakeholders. These include the MoE, State Property Fund (SPF), and line ministries. Approximately 80 percent of SOEs are overseen by seven different institutions (see Table 3), placing a substantial administrative burden and compounding existing resource constraints.

Table 3. Ukraine: Fragmentation of Oversight and Ownership Functions

	Ministry of Economy	Ministry of Finance	Council of Ministers	Line Ministries	Prime Minister's Office	President's Office	State Property Fund
Oversight of SOE sector	✓	✓	✓		✓		✓
Regulation/Policy	✓	✓	✓	✓	✓	✓	
Performance Monitoring	✓	✓		✓			✓
Day-to-Day Management	✓	✓		✓			

11. **Different forms of SOE ownership permissible under Ukraine’s legal framework create a dualistic approach to the exercise of the state ownership function and impacts on the competitive environment.** The legal framework for the management of state assets provides for two main possible forms of ownership: joint-stock companies and unitary enterprises, with unitary enterprises being subdivided into Kazenni and Commercial Entity.⁷ Joint-stock companies are commercial entities and subject to standards of corporate governance applicable to Ukraine-resident privately owned companies, ensuring some limits to government involvement. However, Kazenni and Commercial Entities are controlled by the government, albeit to different extents. Kazenni are fully controlled by the government and are provided with operational management rights. Similarly, Commercial Entities are fully controlled by the government, but are granted business management rights and operate on a for-profit-basis. Within the SOE sector this creates a dualistic approach to state ownership and has negative spillovers for the achievement of a well-functioning competitive environment in the sector and the wider economy.

12. **There are no clear criteria for creating a new SOE and/or assigning functions to an SOE rather than to a departmental agency.** This means that new SOEs are continually introduced, several of which have responsibilities that could have been discharged under the auspices of the relevant government ministry or agency. SOEs are created in circumstances where the state is the sole customer, and/or where their income consists entirely of service fees.⁸

⁷ "Public Financial Management Overview," IMF Fiscal Affairs Department TA Report; Olden et al., July 2014.

⁸ World Bank, 2011.

There are no clear procedures for the winding down unviable or insolvent SOEs, and examples exist of entities that continue to operate long after their originally envisaged purpose.

13. **Ukraine's current conceptualization of the state ownership function, especially that of unitary SOEs, diverges materially from international good practice.** International good practice suggests that regulatory and legal frameworks should be applied uniformly across all categories of SOEs, which is not the case in Ukraine.⁹ In addition, the OECD's guidelines of corporate governance of SOEs promotes the adoption of a centralized approach to the exercise of the state ownership function.

14. **A cornerstone of a robust corporate governance regime for SOEs is the separation of the state's dual role of owner and regulator to address conflicts of interest and enhance accountability (see Chapter IV).** Defining the objectives of the state, implementing checks and balances to maintain independence from government, setting lines of accountability, and detailing performance monitoring requirements helps to manage the expectations and rights of stakeholders and promote effective management of SOEs.

C. Performance Monitoring

15. **The SOE performance management framework requires significant development to be able to achieve its intended purpose.** Previous assessments by International Financial Institutions (IFIs) have identified significant deviation from international good practice and found evidence of inconsistent application and inaction of line ministries when poor performance is detected.¹⁰

16. **Reflecting the differentiation between joint-stock and unitary enterprises, Ukraine's performance management system prescribes different treatment for each form of SOE.** The performance of joint-stock SOEs is assessed using a mixture of commercial and non-commercial indicators, including net profit, average number of employees, payments to social funds and share of profit paid to state budget. Unitary SOEs, by contrast, are assessed on a broader set of criteria encompassing commercial, non-commercial, financial efficiency, innovation, and state asset utilization.

17. **The MoE is empowered to review the performance of the SOE sector but has limited capacity to do so.** The MoE reviews a number of aspects of the performance of the sector, including the financial plans of SOEs, the extent to which line ministries have discharged their oversight function, and it is even entitled to check the individual evaluation results of SOEs and SOE managers. However, the MoE is not in a position to exercise the review function adequately

⁹ "Ukraine: System of Financial Oversight and Governance of State Owned Enterprises," World Bank, 2011.

¹⁰ World Bank, 2011.

due to the size of the SOE sector and questions as to the reliability of information reported by SOEs and line ministries.

18. **Value for money assessments of SOEs are not mandatory and must be requested by parliament.** The remit of the Accounting Chamber of Ukraine (ACU) does not extend to the regular review of SOE performance or the preparation of value for money assessments. However, without adequate inclusion of parliament in the SOE corporate governance framework there are doubts as to parliament's current ability to identify cases for review by the ACU.

19. **The SOE performance monitoring system can be improved through standardization, alignment with private sector practice, and sharpened disincentives for underperformance.** All SOEs, regardless of legal form, should have an ultimate objective to maximize value for the state and as such, should be evaluated on a uniform basis. For performance monitoring to be truly effective, the disconnect between poor performance and consequences should be bridged by a codified hierarchy of consequences for SOE managers and line ministries (see Box 1).

Box 1. Components of a Performance Monitoring System

Effective monitoring of the performance of SOEs helps to drive operational efficiencies and has implications for several areas of corporate governance, including the state ownership function, accountability of SOEs and transparency of the sector. The proper exercise of the state ownership function should be driven by the need to achieve value for money for the owners of SOEs, the general public. An effective performance monitoring system allows the state to determine whether an SOE is achieving its objective and take corrective action if it is not. International good practice recommends the following components of a performance monitoring system for SOEs.

- Collection of baseline information on SOE performance to aid comparison;
- Setting aims and objectives aligned with the overall goals of the government;
- Development of performance agreements to promote the achievement of the SOEs aims and objectives; and
- Development of a set of meaningful and relevant key performance indicators by which performance can be assessed.

D. Financial and Fiscal Discipline

20. **Financial and fiscal discipline in Ukraine's SOE sector is weak.** The lack of discipline is best evidenced by the challenges of tax collection, dividend remittance and a complete absence of any analysis of the returns on capital employed. Tax collection and the remittance of dividends are the mechanisms through which returns on investment are provided to the State as owner of SOEs. They are key metrics in assessing the financial and fiscal discipline in the sector. Previous IFI assessments have found that the collection of taxes from SOEs is weak, in part due to the State Tax Administration lacking a lien over the property of SOEs. Dividends are inconsistently

remitted to the treasury and a 2008 MoE report found that only 71.4 percent of announced dividends were actually received, and 17 ministries were reported to have not met the target regarding the net profitability of their SOE portfolio and transfer of dividends.¹¹

21. **Despite requirements for all SOEs to prepare annual financial statements in accordance with National Accounting Standards (NAS), commercial banks do not use them as a basis for lending decisions.** The commercial banking sector perceives financial statements of SOEs to be of low quality. There is anecdotal evidence to suggest that they base their lending decisions to the SOE sector on non-quantitative factors, such as the role of the government as ultimate guarantor. If this is an accurate reflection of standard practice, it demonstrates the soft-budget constraints placed on the sector and the lack of competitive neutrality.

22. **An effective competitive environment and a better enforcement of competition rules are required.** There is a widespread view within the business community that SOEs tend to reinforce the monopolistic and anticompetitive market structure in key industries. Competition law is largely consistent with international best practices¹² but much remains to be done to create the preconditions for the modernization and restructuring of the Antimonopoly Committee of Ukraine (AMCU) into a truly independent and powerful competition authority.¹³ The AMCU lacks the power to obtain evidence without the voluntary compliance of the parties investigated. In its present form it does not inspire confidence in its ability to promote competition including ensuring that SOEs are competing on an equal footing with private sector participants.

23. **A key focus of future reform directed at the financial and fiscal discipline of the SOE sector should be capacity building to improve the quality of financial statements.** The quality of financial statements produced by the sector prevents their proper utilization in commercial lending decisions, reinforcing soft-budget constraints. The capacity of SOEs to produce high quality financial statements should be enhanced over the medium term.

E. Board of Directors

24. **The current governance framework for SOEs differs according to the legal status of individual enterprises.** While joint-stock SOEs are subject to the CCU, which includes the requirement for an appointed two-tier board of directors. Kazenni and Unitary Entities have no requirement to have independent directors or a supervisory board (see Box 2 for the example of

¹¹ World Bank, 2011.

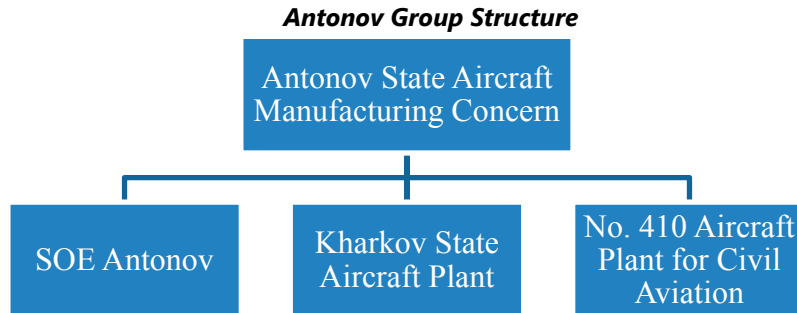
¹² "Voluntary peer review of competition law and policy in Ukraine," UNTAC, 2013.

¹³ The AMCU is a state body with special status, responsible to enforce the state protection of competition in business activity. Created in 1993, it is controlled by the President and reports on its activity to the Verkhovna Rada. It is responsible for encouraging market competition, and preventing abuse of monopolistic positions. It is also responsible for reviewing disputes arising from public procurements.

Antonov). Consequently, line ministries have unfiltered influence in the management of unitary enterprises.

Box 2. Corporate Governance in Antonov

Upon independence in 1991, Ukraine inherited a world-leading aeronautical engineering sector. Many of the state-owned companies operating in this sector have since been privatized. However, the Antonov group of companies, formed in 2010 to bring together a number of unitary SOEs involved in the production and marketing of Antonov aircraft, has been identified as being of central economic and strategic importance.



The 2008 Strategy for Development of the National Aircraft Sector to 2020 aims to improve the performance of the sector through corporate governance reform and modernization. A 2012 OECD corporate government assessment¹ identified several areas of Antonov's governance that deviate from international good practice and that of its competitors. Foremost among these were:

- **Board of Directors:** As with other unitary SOEs, Antonov group SOEs are not required to have a Board of Directors. This has removed an essential layer of political insulation and stewardship.
- **Financial flexibility:** Antonov group SOEs do not have legal title to the assets they operate and have limited capacity to restructure their capital structure. This creates disincentives to efficient asset utilization and limits their flexibility to respond to changes in the economic cycle.
- **Capacity to enter joint ventures:** Antonov group SOEs, as with other SOEs, are not permitted to enter into joint ventures. This severely restricts Antonov's ability to form strategic partnerships in the global aeronautical engineering sector.^{2/}
- **Legal arrangements:** Antonov's privileged position provides for an exemption from certain aspects of Ukraine's legal framework, such as insolvency and bankruptcy. This runs counter to the principles of competitive neutrality and financial and fiscal discipline.

The governance challenges faced by that Antonov were recently demonstrated by the removal of the summary dismissal of Antonov Concern's President by the government.³ An illustration of the absence of political insulation afforded by the existing SOE corporate governance framework.

1/ OECD: A Corporate Governance Assessment of Ukraine's State-Owned Aviation Sector; The Case of Antonov, 2012.

2/ Ukrainian SOEs are forbidden to establish joint ventures by the Decree of the Cabinet of Ministers on Special Issues of State Property Management (31.12.1992). The original purpose of this legislation was the prevention of SOE management corruption, in response to cases of insiders using partnerships with external parties or sham companies to strip assets out of SOEs in the 1990s.

3/ <http://www.janes.com/article/36785/antonov-president-removed>

25. **Boards of Directors, preferably including independent directors, perform a crucial stewardship and oversight function (Box 3).** Boards of directors should act as an intermediary between executive management and the state. They also provide a vital stewardship function that is derived from the fiduciary duty they owe to the SOE and its owners.

Box 3. Components of International Good Practice on SOE Boards of Directors

The nature and duties of boards of directors vary by jurisdiction to fit the specific needs of the country context.¹ Boards of directors take one of two forms. Unitary boards provide both a strategic and oversight function and are typically made up of a mixture of executive and non-executive members. Whereas two-tier boards are formed of a management board and a supervisory board separating the strategic and oversight functions. The duties directors owe generally encompass variations on two central themes: a duty of care and a duty of loyalty to the entity and its owners.

International good practice recommends the consistent formation of effective boards of directors in all SOEs.² However, the effectiveness of a board is reliant on a number of components embedded in the governance framework of a state, as detailed below.

Nomination	<ul style="list-style-type: none"> • The process of nomination and appointment should be codified and aligned with private sector practices.
Composition	<ul style="list-style-type: none"> • Board effectiveness is inherently linked to the ability to board members to exercise independent judgement. Eligibility policies should provide for boards with a balanced mix of experience centred around the central purpose of the SOE in question.
Training	<ul style="list-style-type: none"> • To promote the proper and full discharge of board members' duties it is considered good practice in many countries to provide induction and continuous training opportunities.
Remuneration	<ul style="list-style-type: none"> • Remuneration of board members should strike a balance between being at a sufficient level to attract and retain qualified individuals but also to align incentives over the long-term.
Efficiency	<ul style="list-style-type: none"> • Provisions should be made to promote the efficient running of boards, such as limits to the number of board members and workload per member.
Evaluation	<ul style="list-style-type: none"> • The performance of the board should be evaluated systematically and regularly to ensure it is fulfilling the extent of the specified remit.

1/ World Bank: Corporate Governance of State-Owned Enterprises, a Toolkit, 2014.

2/ Organization for Economic Cooperation and Development: Boards of Directors of State-Owned Enterprises, An Overview of National Practices, 2013.

F. Transparency, Reporting, and Disclosure

26. **The dualism in Ukraine's SOE governance framework¹⁴ extends to disclosure and reporting requirements.** While all Ukrainian SOEs are required to publish annual reports in accordance with Ukrainian NAS, only joint-stock entities are required to make audited financial statements publically available under Article 8 of the 1993 Law of Ukraine on Auditing (amended September, 2006). Although this creates a requirement for the disclosure of financial information, the legal framework of the sector remains silent on the disclosure of nonfinancial information.

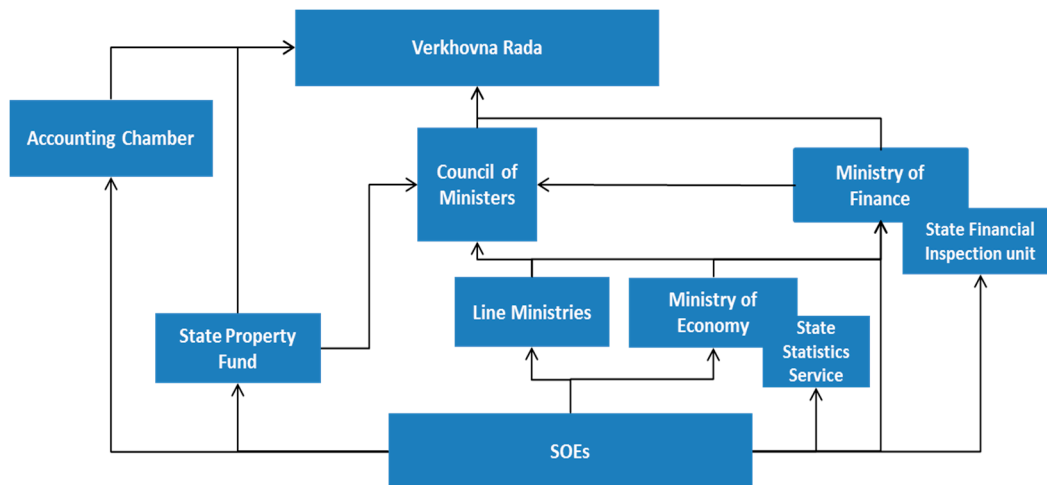
27. **Concerns have been expressed by stakeholders in Ukraine's SOE sector regarding the capacity of SOEs to produce timely and relevant reporting.** As mentioned above, company-level information is the basis on which the transparency and accountability of the sector is achieved. Attention should be paid by the government and donor community to developing the capacity of SOEs to meet internationally accepted reporting and disclosure practice.

28. **The oversight and performance management function for any given SOE is fragmented across a number of different ministries (see Figure 1).** Oversight is supposedly exercised both by individual line ministries responsible for a given SOE, and by overarching bodies such as the MoE and MoF. There is a lack of clarity as to their respective responsibilities. It is not clear to what extent the MoE or MoF are responsible for directly assessing and improving performance within individual SOEs, as opposed to the performance of individual line ministries who may in turn drive SOE performance to achieve their own targets. Fragmentation also leads to conflicting data produced at various points within the institutional framework, even on basic questions such as the number of operational SOEs.

29. **Entities exercising oversight of SOE performance do not have a clear mandate or ability to drive performance improvements.** These could include powers to set remuneration levels for executives, hire and fire management personnel, alter levels of subsidy or required return, recruit external expertise, or authorize restructuring. At present, these powers are fragmented, resulting in overlapping competencies that lead to a lack of clarity as to which institution is responsible. For example, SOEs may be accountable both to a line ministry and to the SPF, both of which are empowered to bring about changes in management. However, the effectiveness of such sanctions is undermined by the legal regime, under which many dismissed managers successfully appeal their termination, often due to direct government intervention.

¹⁴ The dual role of the state as owner and regulator and the legal arrangements applicable to the different types of SOEs affect corporate governance frameworks. The challenges that need to be addressed and incorporated within a strong framework of corporate governance include political interference, dilution of accountability, weak or absence of financial risk management, and inefficiencies arising from weak performance monitoring.

Figure 1. Ukraine: Data Flows Related to the SOE Sector



30. **Despite requirements for reporting and disclosure, transparency and public access to information on the SOE sector is limited.** Ukraine's constitutional and legal framework sets out basic provisions for public access to information. However, certain information relating to unitary SOEs can be classified as of significant national importance under the Law on State Secrets,¹⁵ which creates a fundamental barrier to addressing information asymmetries and achieving transparency. This is of particular concern when the interaction of the Law on State Secrets with the Public Procurement Law is considered, as it can result in the public procurement processes in unitary enterprises becoming opaque.

31. **Codification of consistent reporting and disclosure requirements for all SOEs should be pursued.** The current SOE corporate governance framework provides for different reporting standards for joint-stock and unitary enterprises and only joint-stock SOEs are exposed to the same reporting requirements as the private sector. This is inconsistent with OECD guidelines (and good practice internationally) which recommends that all SOEs should be subject to reporting requirements that are aligned to those of the private sector.

32. **Public access to information could be improved through moderation of the scope of the Law on State Secrets or by requiring publication of financial information on accessible websites (preferably in English as well as Ukrainian).** The impact of the Law on State Secrets on the disclosure of information from unitary SOEs creates a fundamental barrier to achieving a truly accountable and transparent SOE sector.

33. **The current reporting and disclosure framework does not emphasize the role of the legislature in accountability and scrutiny of SOEs.** Aside from publicly available financial accounts, SOEs only report to the line ministries, the MoE and the MoF. This arrangement does not recognize the role of parliament in providing challenge and scrutiny on behalf of the owners of SOEs, the public. Many OECD and non-OECD countries produce and publish an aggregate

¹⁵ Law of Ukraine on State Secret, Vidomosti Verkhovnoii Rady (BBP), 1994.

annual report on SOEs for parliamentary sessions (including the consolidated income statements and balance sheets of all SOEs). Countries with a centralized ownership function, including Chile and India, are more easily able to compile and publish aggregate reports on their websites. Annual reports, together with quarterly reports, allow the parliament and the public to evaluate recent developments in SOEs in an efficient and transparent manner.

34. **Reporting and disclosure of nonfinancial information is not required.**¹⁶ Although the disclosure of nonfinancial information is not a recommendation of the OECD guidelines, it is however a growing trend in the private sector. A reporting framework that promotes the publication of nonfinancial information would enhance the accountability of SOEs with regard to their social and environmental impact and would also bring them in line with good practice (Box 4).

35. **International good practice, such as the OECD's guidelines, establishes that a key recipient of disclosure by SOEs is the legislature as it represents the interests of the owners (i.e., the general public).** Responsibility for reporting to the legislature is determined by the state ownership model adopted and is often shared among a number of governmental bodies. The box below explains forms of reporting to the legislature (Box 5).

¹⁶ International good practices require that companies produce information on environmental issues, social/employee matters, human rights and anti-corruption issues. Information on corporate governance, supply chain impacts, company specific issues and sector specific issues are also important to reinforce transparency towards the market and the public opinion.

Box 4. Lithuania's Transparency Policy for SOEs

The Government of the Republic of Lithuania has set out guidelines for the transparency of SOEs in accordance with its intention to achieve openness, active ownership and good order.^{1/} The guidelines prescribe a framework of corporate reporting applicable to all Lithuanian SOEs. The guidelines set out the following reporting timetable:

- Consolidated annual report presented no later than April 30
- Consolidated interim report (3 month) presented no later than May 21
- Consolidated interim report (6 Month) presented no later than September 15
- Consolidated interim report (6 Month) presented no later than November 21
- Consolidated interim report (6 Month) presented no later than March 15

Reports are prepared by a central institution responsible for the formulation and implementation of good governance policy in the SOE sector. The annual financial statements of SOEs are subject to independent audit in accordance with international audit standards.

The transparency guidelines require SOEs to present the following information in their 6-month interim and annual reports:

- Business strategy, financial and non-financial targets, opportunities and threats
- Assessment of performance relative to targets
- Dividend policy
- Description of significant events during the financial year
- Description of services or products
- Description of major customer groups
- Description of investment of fixed assets and future investment plans
- Analysis of annual labor costs
- Description of ongoing social initiatives and policy
- Information about compliance with transparency guidelines

^{1/} Ministry of Economy of the Republic of Lithuania: Annual Review, Lithuanian state-owned commercial assets, 2009.

Box 5. Forms of Reporting to the Legislature

International practice establishes three forms of reporting to the legislature.^{1/}

1. Periodic reporting typically takes place on an annual basis and is usually aligned to the state budget-making process.
2. Ad hoc reporting is driven by the informational demands of the legislature and usually corresponds to the content of current political discussion.
3. Reporting for approval generally refers to the reporting requirements embedded in the legal framework of SOEs relating to specific actions or transactions, such as the issuance of share capital.

It must be noted that a key issue with reporting to the legislature is that of excessive information which inhibits the exercise of effective oversight, in addition to the technical skills and capabilities within the legislature to scrutinize the data transmitted.

^{1/} "Boards of Directors of State-Owned Enterprises, An Overview of National Practices," OECD, 2013.

G. Recommendations

Medium-term measures (6 months to 2 years)

Recommendation 2.1 – *Develop a single multi-purpose reporting framework under the responsibility of a single institution, which could satisfy the informational needs of all stakeholders (governing bodies, investors, supervising ministries, budget division of MoF, the tax authorities, the legislature, and the public). This would reduce the volume of ad hoc queries and tailored responses to which SOEs currently need to respond, freeing up reporting capacity within SOEs. (July 2015)*

Recommendation 2.2 – *Amend the Law on State Secrets to enhance transparency and corporate governance in the sector. (September 2015)*

Recommendation 2.3 – *Improve transparency of the sector by implementing the requirements for web-based reporting at both the SOE-level and the ministerial level. (July 2015)*

Recommendation 2.4 – *Develop and implement a capacity building plan at all levels of the SOE institutional framework to promote effective and proper transparency, accountability and oversight of the SOE sector (September 2015). Particular areas of capacity building could include:*

- Training and empowerment of SOE boards of directors.
- Upgrading of financial accounting and reporting skills in SOEs and line ministries.
- Increasing human resources in the MoE.

Recommendation 2.5 – *Restructure the Antimonopoly Committee to ensure that it is fit for purpose and has the capacity, resources and necessary degree of independence to enable it to conduct thorough investigations of anticompetitive practices including those of SOEs, and of complaints concerning public procurement procedures. (September 2015)*

Recommendation 2.6 – *Define clear criteria for the creation and disbanding of SOEs. This will prevent the proliferation of SOEs, and also prevent the establishment of SOEs with organizational objectives that would be better satisfied within the framework of existing government ministries and agencies. (September 2015)*

Recommendation 2.7 – *Enhance the role of the parliament in the SOE governance framework through:*

- The requirement for mandatory annual reporting by SOEs'
- The submission of annual value for money assessments of SOEs above a predetermined turnover threshold by the Accounting Chamber.

(September 2015)

Recommendation 2.8 – *Eliminate the dual approach to the SOE corporate governance framework to provide for a standardized approach to the governance of all SOEs that is aligned to that of*

the private sector. This will enforce the principle of competitive neutrality, will create positive capital market effects for SOEs and will foster good governance throughout the sector. (January 2016)

Recommendation 2.9 – *Reform the SOE performance management system* to ensure that all SOEs are evaluated on a standardized set of financial and nonfinancial KPIs and that a codified hierarchy of consequences for poor performance is put in place. (September 2016)

III. IDENTIFYING, REPORTING AND MITIGATING FISCAL RISKS FROM SOES

A. Background

36. **Large fiscal risks emanate from the SOE sector.** These originate from direct budget costs related to shrinking dividends and increasing subsidies to cover loss-making activities by non-commercial and commercial SOEs, as well as contingent fiscal risks emanating from the outstanding stock of state guarantees on SOE debt, serial underinvestment, which could require future capital injections and other obligations by SOEs which could eventually fall on the budget. In 2014, the authorities intervened with ad hoc measures to support fiscal consolidation in order to achieve the budget targets. These measures included cost reduction initiatives by SOEs, which were expected to yield savings of about UAH 2 billion through higher dividends to the budget. In addition, the Verkhovna Rada passed a resolution to reduce administrative staff in SOEs and limit wages.

37. **In addition to direct costs to the consolidated budget, SOEs may also generate other sources of budget risks.** Indirect costs of SOEs include, among others, the foregone income for the budget related to the assets managed by SOEs. Given the level of these assets, which are estimated by the MoE at UAH 870 billion, and an opportunity cost of this public capital equivalent to the long-term growth of nominal GDP (about 8 percent per year), the SOE sector could have provided a budget flow around 5 percent of GDP each year.¹⁷ In fact, the sector is a loss for the budget and a source of potential future fiscal sustainability risks.

B. Specific Fiscal Risks Emanating from the SOEs Sector

38. **Capacity to assess fiscal risks emanating from SOEs is underdeveloped.** There is capacity in the MoE to perform this analysis, but at present no one is tasked with doing so. Macroeconomic assumptions for the budget are prepared by the macroeconomic unit in the MoE. The medium-term economic forecasts are subject to discussion on credibility and internal consistency and are used as inputs to project budget outcomes and inform fiscal policy formulation. While several alternative macroeconomic assumptions are tested during the budget

¹⁷ The opportunity cost is the foregone income for the budget of the return on assets in SOEs assuming this return is the same as the interest rate on sovereign bonds.

preparation process, sensitivity analysis of the impact on the budget are not disclosed to the Verkhovna Rada or the public, nor are they used as an input to government decisions.

39. **Stress test scenarios are not used to assess the impact on the budget of adverse shocks affecting the performance of SOEs.** While SOE financial plans approved by supervising ministries are subject to revisions based on different assumptions of key macroeconomic variables, no structured process exists to assess risks to SOE performance in a homogenous way across sectors and investigate their budget impact. This weakens informed discussion on fiscal policy, its risks over the short and medium terms, the implication for public debt sustainability and efficient allocation of public resources according to policy priorities. It also exposes the budget to financial emergencies that could be mitigated and better managed by implementing a comprehensive fiscal risk framework.

40. **In recent years, many countries have introduced processes to identify, report, and mitigate fiscal risks.** This frequently includes the preparation of a fiscal risk document to be appended to the budget (Appendix I identifies the key elements to consider in putting together a fiscal risk statement). In countries that produce this document¹⁸ fiscal risks are assessed based on the analysis of the impact of a variety of shocks (see Appendix II).¹⁹ These include macroeconomic deviations from budget assumptions on key variables such as economic growth, inflation, interest rates, and international commodity prices when relevant. This assessment is typically carried out through scenario and sensitivity analysis, and stress tests of fiscal aggregates. In some cases, such as in the United States, uncertainty surrounding baseline projections of fiscal variables is represented through fan charts that depict probability distributions around a central point estimate of the fiscal indicator.

41. **Information on contingent liabilities, such as state guarantees on public sector loans, is also typically included in the fiscal risk statement.** The information reported emerging from contingent liabilities include the face value of the stock and flows on guaranteed loans, as well as measures of the expected cost of outstanding guarantees and the likelihood of the guarantees being called. In some cases, information on guarantee premia collected is also presented. Gross exposure to risks from public-private partnerships is also useful when these projects represent important fiscal risks. Finally, analysis of public asset-related risks is presented by reporting consolidated fiscal aggregates for the whole public sector, including SOEs, and assessing potential budget risks from adverse shocks hitting the SOE sector.

42. **Measuring the impact of fiscal risks emanating from SOEs on public sector balance sheets can contribute to the assessment of the impact of SOEs on government finances.**

¹⁸ Several OECD countries have some form of fiscal risk statement and some emerging economies, including Brazil, Chile, and Indonesia have started to disclose fiscal risks during budget preparation.

¹⁹ See, for an example of fiscal risk statements, the documents published by the Australian government http://www.budget.gov.au/2014-15/content/bp1/html/bp1_bst8-01.htm and the government of the Philippines http://www1.dbm.gov.ph/?page_id=2877.

SOEs operations do not only affect budget flows, but also have an impact on the stock of assets and liabilities managed by the public sector. Limiting the analysis of fiscal risks to traditional budget indicators would therefore convey an incomplete picture of fiscal risks. A complete assessment of these risks would require the analysis of the implications of SOEs operations on the government budget, covering revenues, expenditure, and financing. Availability of information on changes in the stock positions of assets and liabilities over the course of a financial year is also important. Stock levels are affected by economic transactions, as well as valuation changes and other flows affecting the stocks (e.g., privatization and changes in foreign exchange rates) and provide information to calculate key summary indicators of fiscal sustainability, including a measure of net public worth.

43. **A program to move to a reporting system that includes public sector balance sheet data compilation should be the ultimate in strengthening fiscal policy preparation and execution.** However, in many countries this process can only be achieved gradually, as data requirements are demanding and compilation of nonfinancial assets in the public sector balance sheet is difficult. Nonetheless, countries have started this process by providing basic information, such as inventories of state assets, to compile balance sheet information and link them to traditional budget indicators as a tool to monitor fiscal risks. While producing full information on the public sector balance sheet may be beyond the scope of government policies in the short run, measures could be enacted to produce and use information already available and extend the coverage of existing registries (see Chapter IV) to provide full disclosure of public assets and liabilities and use public net worth changes to inform fiscal risk assessment and disclosure.

Coverage of the public sector

44. **The size of the public sector is subject to large uncertainty.** This risks considerable underestimation of the potential budget implications emanating from the public sector. There are different sources of information on the list of SOEs, which include data provided to the MoE by the state statistical service, the database compiled by the MoE unit responsible for public enterprise coordination and monitoring, and the list of companies registered with the State Property Fund (SPF). Information on the coverage of SOEs is also made complex by the fragmented legislation and different categories of enterprises (Chapter II). Finally, there is only partial information on the degree to which many of the SOEs that are contained in different databases are operational. The range of SOEs recorded in different data registries varies from about 4,500 to less than 1,800. Also state assets held by subnational governments may not be included in the data and comprehensive information of land assets and commercial real estate held by public entities is missing (see Chapter IV).

45. **Including coverage of SOEs alone is insufficient to enable the creation of a comprehensive public sector balance sheet.** There is also a need to include information on the

wider category of state assets, including government real estate in any comprehensive register.²⁰ Many countries have been moving away from traditional information systems whereby data on government activities were confined to financial flows and economic transactions. In order to guide fiscal policy formulation and better assess fiscal risks both in the short run and over the medium term, additional fiscal indicators, such as the Net Public Worth,²¹ have been compiled on the basis of information on the public sector balance sheet. This includes assets and liabilities controlled by the general government and companies where the government has a significant stake or that are relevant for public policies. Compiling a balance sheet of the government is also compliant with international statistical standards on fiscal statistics, such as the Government Financial Statistics (GFS) system²² and the European System of National Accounts (ESA).

46. **Determining the coverage of the public sector is essential in understanding the role of government in the economy and assessing fiscal risks.** All state assets should be registered in a database where information on physical characteristics of these assets, as well as financial information, can be collected and analyzed properly. While the bulk of economic resources managed by SOEs can be accounted by the top 100 operating companies, this information may include important gaps and significant activities could escape government scrutiny, unless a comprehensive register of SOEs is created. This database should also cover joint stock companies under the control of the state, as well as unitary SOEs and companies where the state has minority stakes. Using this broad definition of public sector would ensure that all companies that manage state assets are monitored.

Subsidies

47. **Direct subsidies from the budget to SOEs are significant and could pose risks for fiscal sustainability in the future.** They are estimated to have reached about 2.5 percent of GDP in 2014 on the basis of MoF estimates and are projected to fall slightly in 2015. A large recipient is the energy and coal sector. The sector alone accounts for about 1 percent of GDP (see Box 6). Subsidies have been increasing over time reflecting large losses at SOEs (Table 4) and reflect mostly the gap between the production cost of goods and services provided by SOEs and the price charged to consumers or intermediate users. Large subsidies to finance government support programs can be found in different sectors, including energy, infrastructure and agriculture, and local governments (Table 4).

²⁰ Examples would include Australia, New Zealand, the Scandinavian countries, and Lithuania.

²¹ The public sector balance sheet can help diagnose vulnerabilities that are not immediately visible in the budget. See, Da Costa M. and V. H. Juan-Ramon, 2006, "The Net Worth Approach to Fiscal Analysis: Dynamics and Rules," IMF Working Paper 06/17 (Washington, International Monetary Fund).

²² See International Monetary Fund, 2001 and 2014, Government Finance Statistics Manual, (Washington, International Monetary Fund) and International Monetary Fund, 2005, Using the GFSM2001 Statistical Framework to Strengthen Fiscal Analysis in the Fund (Washington, International Monetary Fund).

Box 6. Coal Mining Sector Subsidies

The energy sector is supervised by the Ministry of energy and coal mining. This sector is one of the largest in the Ukrainian economy with a large presence of the public sector. There are about 450 SOEs in the sector whose oversight and management depends on the ministry. Of these, 314 are unitary public enterprises and 140 are joint stock companies, in which the state has a significant share. The majority of the companies are in the mining sector and coal industry with 216 state enterprises. There are also 38 companies in the energy generation and distribution sector, 28 companies in the nuclear energy sector and 32 companies in oil and gas extraction, refining and distribution.

Financial plans for these companies are weak. There are, however, exceptions in the case of large companies with strategic importance for which the oversight function is carried out by the Cabinet of ministers, with the technical support of the MOE together with the energy ministry. These include large companies such as Naftogaz, as well as companies responsible for generation and distribution of nuclear power and hydroelectric energy. Corporatization in the sector is not frequent, except for larger companies such as Naftogaz, where director boards exist although they are composed of government officials.

Direct budget subsidies in the energy sector are concentrated in the coal mining industry. In the 2014 budget there were 5 programs supported by direct budget transfers. These cover different activities and purposes. First, the subsidy aim was to cover the cost of restructuring coal mines and preparing for liquidation the ones that were not viable or where coal had been exhausted. Second, it provided financing for investment in safety of mining industry, work accident prevention, and indemnities. The third purpose of the subsidy program was to cover the gap between the price charged by coal mines to energy generation companies (UAH 800 per tonne in 2014, raised to UAH 1,100 per ton in 2015) and the production price. The latter ranges between UAH 1,000 and UAH 6,000 per ton, depending on the coal quality and the degree of complexity in coal extraction. Wage costs account for a significant share of production costs ranging between 30 to 60 percent.

Direct budget subsidies have been reduced in the 2015 budget. In 2014, the budget cost to finance the coal mining support program was about UAH 9 billion (almost 1 percent of GDP). In the 2015 budget the budget financing of these programs was largely discontinued. This reflects various factors, including the inability to manage the operations of coal mines in war-affected areas, the increase the price charged to energy generation companies, and the phasing out of activities in liquidated companies. However, as the subsidy rate for coal production remains large, as prices charged to energy providers only cover on average 30 percent of production costs, the implicit budget cost is significant. Estimates by the supervising ministry put this cost in the range of UAH 2 to 4 billion (between 0.1 and 0.3 percent of GDP).

48. **While it is difficult to have comprehensive information on the subsidy rate, this is estimated at around 60–80 percent in many sectors, including energy, coal, and agriculture.**²³ In the 2015 budget, direct subsidies have been limited to 1.3 percent of GDP as a result of the phasing out of the support to the mining sector and the reduction in other subsidies. However, no structural cost containment measure was implemented in the SOE sector and lower budget support could result in higher SOE losses and depletion of public assets managed by public enterprises. In the absence of correction measures, both fiscal deficit and public debt may need to absorb these losses.

49. **Subsidies are not well targeted and tend to be negotiated without clear prioritization during the budget preparation process.** Typically, line ministries are responsible for the formulation of requests for budget subsidies in the sectors for which they manage and oversee SOEs. Initial subsidy requests are then discussed with the MoF officials and final decisions on the amount of the subsidy to be included in the budget are made. These decisions take into consideration the financial envelope of the budget and the related financing constraints. The process does not ensure that resources are allocated to meet policy objectives and subsidies tend to reflect a combination of factors, including historical support levels, estimated losses in SOEs, and wage cost dynamics in SOEs.

50. **Two major types of fiscal risks could emerge from the subsidy program.** First, public resources could be diverted to non-effective uses on the basis of the need to continue to support otherwise non-viable activities by SOEs that benefit from these subsidies. Second, the subsidy level may not be sufficient to cover structural gaps in the SOE production system, thereby generating short-term pressure on the budget to cover the funding gaps that may emerge during the year, or generate unfunded liabilities, which would have later impact on public finances.

²³ Based on the price charged versus the overall cost of production. Source Line Ministry data.

Table 4. Subsidies and Current Transfers to Enterprises in Consolidated Budget

	Total
	23.5
Coal industry	1.5
<i>restructuring</i>	<i>1.2</i>
<i>rescue measures</i>	<i>0.2</i>
Debt service payments	4.5
<i>EURO 2012</i>	<i>2.7</i>
<i>Cyclone-4</i>	<i>1.4</i>
<i>Ukrmedpostach</i>	<i>0.3</i>
Financial support for national theaters	0.5
National and state art groups, concert and circus organizations	0.3
Heat generating plants (except for fuel gas)	0.5
Special Communication and Information Protection	0.1
Affordable housing	0.2
<i>housing subsidy for young people and singles</i>	<i>0.05</i>
<i>recapitalization of the State Fund for Youth Housing</i>	<i>0.04</i>
<i>contributions for housing loans</i>	<i>0.09</i>
Contributions to the fund "Shelter" NSC "Vector"	0.7
Health care	0.1
Support for NGOs and disabled veterans	0.1
<i>measures for rehabilitation of disabled persons</i>	<i>0.01</i>
<i>support of civil society organizations and disabled veterans</i>	<i>0.08</i>
Transportation of senior officials	0.1
Current transfers to enterprises	0.4
<i>activities of civil defense forces</i>	<i>0.03</i>
<i>shipping locks</i>	<i>0.04</i>
<i>financial support for sport NGOs</i>	<i>0.03</i>
<i>land reform</i>	<i>0.03</i>
<i>other transfers to enterprises</i>	<i>0.3</i>
Local governments	14.6
<i>housing:</i>	<i>5.5</i>
<i>city improvements</i>	<i>3.6</i>
<i>municipal grants Pidprymstavam</i>	<i>1.5</i>
<i>coal industry</i>	<i>0.4</i>
<i>other housing costs</i>	<i>0.7</i>
<i>transportation</i>	<i>1.3</i>
<i>current repair and maintenance of roads</i>	<i>4.7</i>
<i>theaters, philharmonic, other events</i>	<i>1.4</i>
<i>physiotherapy</i>	<i>0.3</i>
<i>media support</i>	<i>0.2</i>
<i>conservation measures</i>	<i>0.3</i>
<i>other local spending</i>	<i>0.2</i>

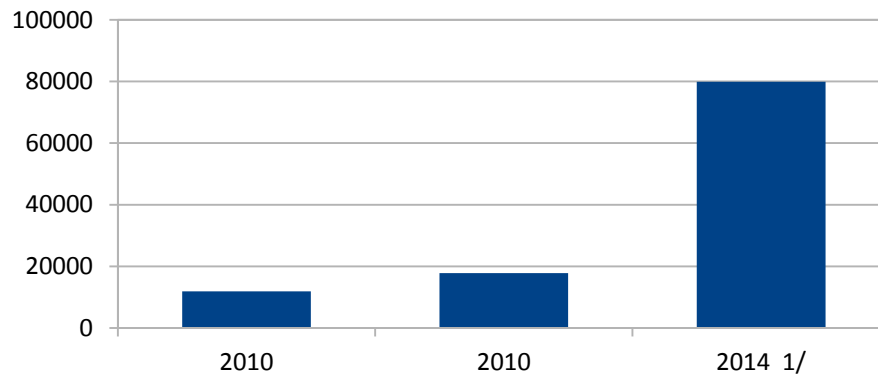
Source: MoE data

51. **While subsidies have been capped at UAH 24 billion in the 2015 budget, this level may be insufficient to guarantee that some public enterprises do not incur further losses.** The gap could be as high as 2 percent of GDP in 2015, excluding Naftogaz on account of exchange rate depreciation and impact of the conflict in the Eastern regions. Moreover, the reduction in budget funding of the subsidy program was not a result of SOE restructuring or sharper targeting of the financing to priority programs, but mostly the effect of phasing out transfers to coal mines in war-affected zones, and cutting funding to another third of mines in the rest of Ukraine. The latter are estimated to be likely to incur in financial losses ranging between UAH 1 to 3 billion as a result of this measure. This funding gap could eventually have to be borne by the government budget.

52. **Indirect subsidies are also large and are a threat to fiscal sustainability.** These include transfers of securities from the central government to loss-making SOEs as recapitalization, in order to provide liquidity to these companies.²⁴ Possible risks to the budget arises from the potential for further losses that could be incurred by loss-making SOEs as a result of unanticipated shocks to the macroeconomic variables, including the exchange rate which affects the price of imported gas. Shocks to international prices of oil and gas could also affect the budget.

53. **Loss-making SOEs are an additional source of fiscal risks.** Losses have been increasing over time (Figure 2). While current losses are high at more than 1 percent of GDP (excluding Naftogaz), the operation of several SOEs is affected by the potential impact of shocks.²⁵ Loss-making companies that are not commercially viable are already generating wage arrears and would eventually require some form of government support as additional above-the-line subsidies or below-the-line government recapitalization, as in the case of Naftogaz.

Figure 2. Ukraine: Recent Trend in SOE Net Financial Losses



Source: MoE data and IMF staff estimates.

1/ Data for the first three quarters of the year.

²⁴ For example, in the case of the public gas sector holding Naftogaz, these indirect subsidies, which are not accounted in the budget but increase the level of public debt, amounted to about 6 percent of GDP in 2014 and are estimated at above 2 percent of GDP in 2015.

²⁵ For example, the food and grain state company reported in 2014 an estimated loss of about UAH 1 billion, down from a planned net profit of similar magnitude, reflecting exchange rate depreciation during the year, which cost some UAH 2 billion or 0.1 percent of GDP to the company in higher import prices. Additional losses could stem from war-affected collapse in mining production, cargo traffic and rolling stock depletion (estimated at USD 800 million by the supervising ministry), and contract cancellation by Russian clients in the space and military industry (potentially 80 percent of revenue for companies managed by the State Space Agency or UAH 2 billion per year).

Financial guarantees

54. **Government guarantees granted to SOEs loans are large at more than 10 percent of GDP as at end-2014.** Loans with government risk coverage are concentrated in the energy sector, food, and infrastructure. They include international bonds issued by Naftogaz (accounting for about a third of total guarantees), as well as loans by official and private institutions to SOEs for restructuring, investment and liquidity purposes (See Appendix III). About three quarters of the loans are in foreign currency and are exposed to exchange rate risk, which could affect significantly the capacity to repay by the borrower.²⁶

55. **Fiscal risks emanating from these guarantees include the possible call of the contingent liabilities and the foregone revenue from guarantee fees.** Borrowing by loss-making and structurally non viable public enterprises raises the issue of their ability to service debt without direct or indirect budget support. For example, Fininpro does not generate revenue streams through the infrastructure to cover the debt service cost, which is provided by budget subsidies amounting to UAH 2.7 billion in 2015. The likelihood that debt would be repaid for the 65 contracts managed by Fininpro with other public enterprises (which were on-lent borrowed funds for a fee to build sport-related infrastructures) is deemed to be very low. Essentially the debt of these non-commercial operations is a government liability and should appear in the government debt figures.

56. **The MoF estimates that half of the contingent liabilities stemming from state guarantees should be considered direct public debt.** As such they would increase the ratio of direct public debt to GDP to about 70 percent in 2014, up by almost 10 percent compared to current figures.

57. **Additional budget costs stem from the foregone revenue on guarantee fees.** As guarantee fees are not charged at all or are insufficient to cover the risk of non-payment by the borrower, the fiscal risks indirectly assumed by the budget are high. If the average guarantee fee was around 500 basis points, the indirect fiscal cost of these foregone revenue would total almost UAH 8 billion (0.5 percent of GDP). Debt contracted by the railway public enterprise and falling due in the next years amounts to UAH 32 billion (2 percent of GDP) and in the absence of restructuring could represent a fiscal risk.

58. **Existing borrowing procedures for SOEs do not include sufficient safeguards to insulate the budget from having to cover future repayment risks.** While loans to SOEs are supervised by the MoF and borrowing with government guarantees is subject to regulations and controls, there is no assessment of the capacity to repay debt and the resilience of the borrower to shocks to ensure that debt is serviced under economic conditions which differ from the assumptions in SOE financial plans. There are no limits on the flow of new guarantees (a

²⁶ For example, a 10-percent depreciation of the hryvnia would increase the nominal value of debt by almost 1 percentage point of GDP.

5-percent threshold based on annual government revenue which was proposed by the MoF was not introduced in legislation). The only formal constraint in the budget code is that the overall amount of public and publicly guaranteed debt does not exceed 60 percent of GDP. However, this threshold has already been exceeded with public and publicly guaranteed debt expected to reach almost 90 percent in 2015. As SOE loans carry implicit government guarantees, because SOEs typically do not own assets as collateral, the government is the ultimate risk bearer. In fact, financial plans are frequently based on unrealistic assumptions, which lead to optimistic projected performance indicators hiding SOE vulnerabilities and the related risk of defaulting on debt obligations, which could affect the budget.

Dividends

59. **Dividend policy governance aims at lowering budget pressure often to the detriment of maximizing SOE value.** There is an inherent tension between short-term budget objectives to increase non-tax revenue through higher dividends, in order to contribute to the required fiscal consolidation, and using resources to increase the efficiency of public enterprise operations. Dividend policy needs to strike a balance between these two objectives, with a view to protecting public sector asset portfolio performance and limiting budget risks. Governance of dividend policy is fragmented due to the multitude of authorities supervising SOEs and the absence of economic criteria to define dividend plans. These are frequently based on ad hoc criteria, generally expressed as lump-sum values that do not correspond to actual ex post profit realization, and rely on information from SOE financial plans that are typically biased. As a result, realization of transfers to the budget from SOEs results in lower flows than expected on the basis of financial plans, reducing budget revenue and creating risks to the deficit target.

60. **Dividend policy also contributes significantly to increase in fiscal risks.** Dividends from public enterprises to the consolidated government budget have declined steadily in recent years and reached a meager UAH 3.4 billion in 2014, in comparison to face-value assets of UAH 870 billion in SOEs.²⁷ The return on these assets in the form of profits for the company and related non-tax revenue for the budget underperforms various benchmarks, including the economic growth rate of the last decade and the cost of borrowing for the sovereign.²⁸ These costs could escalate, as loss-making SOEs continue to generate low returns, limiting resources available to invest in aging stock²⁹ and put further pressure on state finances.

²⁷ Based on MoE aggregate data for the SOE sector in the third quarter of 2014.

²⁸ Using the benchmark return rate above is a crude measure of the opportunity cost of capital on the basis of the likely cost that the sovereign would face if it had to borrow from the capital market the funds allocated to SOEs. The rate of return in this respect is leading to a floor estimate of the fiscal cost as it does not take into account any additional profit on top of the capital cost.

²⁹ For example, the transport infrastructure sector and the aircraft manufacturing sector require combined investment levels exceeding 1 percent of GDP over the next five years.

Pricing policy

61. **Pricing policy is left to sector ministries and SOEs themselves.** Energy subsidies are particularly large in size. They were estimated at 7.5 percent of GDP, including indirect subsidies. They stem from lower prices charged to final consumers and energy distribution companies, as well as lower sale prices (compared to international benchmarks) of domestically extracted and refined gas sold on the local market by Naftogaz. During 2014, tariff increases were introduced for consumers and gas price charged to energy distribution companies, which in part reduced the subsidy rate but was offset by the exchange rate depreciation. As a result, the subsidy rate remains high at about 80 percent and the cost of energy subsidies, including indirect subsidies is estimated to be 6–7 percent of GDP. In the absence of further price corrections, the government budget would need to fund losses incurred by Naftogaz as a result of the subsidy policy. While these subsidies are large, they do not benefit the poor and are captured mostly by middle-income and higher income households and those living in urban areas.

62. **Hidden fiscal costs of SOEs are also evident when looking at cross-subsidization.** For example, in the railway sector SOEs charge higher prices for cargo transits than for passengers' based transportation. The subsidy rate varies from 40 percent to 70 percent in different sectors of the passenger transit, with the highest subsidies for local train transportation and the lowest for inter-city high-speed traffic. The cost of the subsidy is estimated at about UAH 8 billion. Recent increases in cargo railroad tariffs by 30 percent decided at the end of January would only offset the extra cost of production reflecting lower traffic revenue from war-affected regions and exchange rate depreciation and would not reduce the overall subsidy rate. If cross-subsidization were to be discontinued and prices were not adjusted accordingly for consumers, Ukrzaliznytsia³⁰ would face financial losses of about UAH 1 billion, which could eventually fall on the budget. Cross-subsidization is also prevalent in the electricity sector, where industrial users are charged more than the marginal production cost to subsidize consumers and investment in hydro power and nuclear energy provision capacity. The cost of this indirect subsidy for the hydro energy sector alone is about UAH 1 billion per year.

Wage and employment policy

63. **The SOE sector is a large public employer.** At more than 1 million employees, the sector accounts for more than 2 percent of GDP in wages, more than one quarter of the consolidated government budget wage bill and about 10 percent of SOE revenue from sales. With a large share of SOEs making losses, the sector is in part playing the social role of employer of last resort. For example, the railway SOE estimated an excess workforce of about 100,000 or one-third of the staff with an extra annual cost of UAH 1 billion. Wage arrears in SOEs also pose risks to future budgets, as obligations from payments may fall on the central government. These arrears have reached over UAH 650 million in the first nine months of 2014, up from less than

³⁰ Ukraine railways.

UAH 300 million in the previous year. They are mostly concentrated in the mining sector and in the food industry.

64. **Employment levels have remained stable in recent years and wage costs have increased, notwithstanding the worsening financial performance of the SOE sector.** An illustrative simulation highlights the extent of the fiscal risks from the current situation. If one quarter of the employees in loss-making companies were to lose their job, there would be about 300–500 thousand additional unemployed in the economy and higher fiscal risks due to pressure on social spending, including for unemployment benefits and social assistance. Additional fiscal costs from employment in SOEs stems from in-kind benefits accruing to workers. For example, several SOEs run hospital facilities for their employees. For the railway company alone, these cost about UAH 150 million per year.

65. **Wage policy decisions are taken by supervising sector ministries along with the coordinating MoE and unions.** These tripartite agreements typically define the financial dimension of the contract as well as nonfinancial working conditions. While it is common in other countries to have such tripartite agreements to define wage and employment policies, in Ukraine SOE financial performance and the company medium-term viability only play a minor role in wage setting. The overall remuneration is also composed of special allowances that cover as much as one-third of the final wage. These include seniority-related allowances and other bonuses related to specific functions. Performance-related wage components are typically small or non-existent. In some cases, employees receive a component of the total remuneration package in the form of social benefits, such as access to hospital services in the transport industry, and discounted food products in the aircraft manufacturing sector.

66. **Wage policy decisions need to take into account the commercial and non-commercial nature of SOE activities.** In December, Parliament approved a law capping wages in the public sector, including SOEs, to 10 times the minimum wage to SOEs that receive subsidies from the budget, except for strategic companies. While this measure may be appropriate for non-commercial activities carried out by SOEs that are equivalent to government services provided by public servants, such as post services or public infrastructure investment, this policy may result in significant operational difficulties in commercial enterprises that compete with the private sector and need to have the capacity to attract and retain adequately skilled staff.

67. **Evidence points to large differences between average salaries in the SOE sector and other sectors in the economy.** Based on staff estimates³¹ wages in SOEs exceed private and government wages in many economic sectors. For example, in the transportation sector average monthly wages are about UAH 3,800 in the SOE sector, compared to UAH 3,400 in the government and UAH 3,600 in the private sector. Similarly, in the food processing industry wages

³¹ See Coady et al (2014).

are UAH 3,900 in public enterprises and UAH 2,200 in the private sector. Differences are of similar magnitude also in the IT sector, defense, education and sport, while they are less marked for health care and construction. These differences may reflect the complexity of the business, different skill level requirements between SOEs and private sector, and the seniority and bonus components of the remuneration. Nonetheless, wage costs could dent SOE profits and represent a fiscal risk, in particular in non-commercial public enterprises that carry out activities akin to general government services that should in principle have wage costs of a similar magnitude.

Tax policy

68. **SOEs are used to earmark certain taxes, which limit budget flexibility.** Some SOEs collect tax and non-tax revenue on the basis of government regulations and earmark these revenues to provide goods and services.³² While the practice of revenue earmarking is common for specific agencies such as social security funds, where social contributions need to be set aside to pay future benefits in other cases revenue earmarking reduces the budget flexibility to allocate taxpayers money to priority expenditure areas. It may also lead to inefficient spending and over provision of goods and services by SOEs that do not match demand needs and government priorities. Finally, earmarking may lead to higher spending on wages and purchase of goods and services by SOEs, which would affect profits and government budget dividends.

69. **Additional fiscal risks could stem from preferential tax regimes for SOEs.**³³ While the prevalence of these tax expenditures is unclear due to lack of information, tax exemptions may harm the budget and open fiscal gaps with no efficiency motivation. Land tax exemptions are also frequent for strategic enterprises, including the 11 operating companies managed by the State Space Agency. The UKRhydroenergo also benefited from a UAH 300 million profit tax discount until January 2015. Disclosing the amount of these exemptions and assessing their economic purpose against alternative uses of public finance resources would add to budget transparency and contribute managing fiscal risks.

C. Managing Fiscal Risks from SOEs

70. **Public disclosure of fiscal risks can help manage budget vulnerabilities more effectively, improve economic efficiency, and lower debt service costs.** Fiscal risk identification is critical to raising awareness as to the sources of potential threat to budget plans. This is particularly relevant for the public enterprise sector, where important fiscal risks are concentrated. SOEs with commercial activities should be separated and treated differently from non-commercial activities that could be carried out by general government agencies with similar policies for wages, employment, and governance as the rest of the general government

³² For example, the unitary SOE Ukrecources charges fees to importers based on the weight of packaging materials they use for their products, collecting about UAH 100 million a year to finance recycling activities, which they share with the private sector that covers two-third of the market and some local governments.

³³ E.g., until recently VAT exemptions were in place for Naftogaz.

(see Chapter IV). For those mainly market based entities that are in receipt of subsidies to carry out public or community service obligations, the level of subsidy should be recorded explicitly and recorded separately in the financial statements of the entity and the government budget. It would also help enhance fiscal transparency and open the budget process to public scrutiny (see Box 7 for an example of linking fiscal risks disclosure and fiscal transparency in the case of New Zealand). Fiscal transparency strengthens public finance policy credibility and lowers the cost of budget financing. It also helps anchor expectations by markets and economic agents, improving fiscal policy communication by the government as to its ultimate objectives and measures to achieve them.

71. **Assessing fiscal risks will require a scaling up of analytical capacity.** Risk assessment tools including scenario and sensitivity analysis of budget plans on the basis of shock assumptions and the underlying assessment of the likelihood of shock occurrence and their expected fiscal impacts are key to informing fiscal policy formulation and manage risks effectively. In this respect, the budget documentation could include, as an annex, an analysis of fiscal risks and identification of budget contingencies and mitigation actions, following good international experiences. This can also help frame the discussion on fiscal policy objectives, risks, and their economic implications with Parliament and the public at large at the time of the budget approval. It would contribute to raising awareness of fiscal policy trade-offs and enhance the transparency of the budget process.

72. **Fiscal risks related to SOEs are particularly significant in Ukraine and would need to be investigated as part of the assessment framework.** Both general fiscal risks and more SOE-specific risks could have important consequences for public finances and require careful identification, assessment and management. Extending the coverage of public sector information to include all SOEs where the government has a stake, extending the available information on public sector balance sheet to include all liabilities and assets, including land and real estate would help raise awareness on potential value and risks for the budget of the SOE sector. This would also help enhance fiscal governance by providing valuable information on the links between the SOE sector and the budget and inform policy decisions on dividend and subsidy policies, while minimizing risks stemming from contingent liabilities.

73. **Risk mitigation actions could be included in the fiscal risk statement following the example of international practices.** These could include: (i) policies to align wages, tax and benefits for non-commercial entities with the rest of the public administration; (ii) creation of contingencies in the budget to absorb potential shocks; (iii) phasing out energy subsidies and gradually moving to cost recovery for other services, such as transportation; (iv) strengthening the governance arrangements surrounding SOE borrowing by setting debt limits which take into account the risk of state guarantees being called; (v) disclosing on budget indirect subsidies and

tax expenditures and making them contingent on available budget funds; (vi) charge an adequate risk-based price for state guarantees provided to public enterprises.³⁴

Box 7. Fiscal Risks and Fiscal Transparency: The case of New Zealand

Before the introduction of the Fiscal Responsibility Act in 1994, fiscal risks were not managed. There was in general a culture of risk aversion in the management of fiscal policy and risk reporting was confined to internal practices within the Treasury. Most efforts were dedicated to the estimate of a fiscal baseline scenario and no risk management plan was in place.

The new fiscal legislation had fiscal transparency as its main target. The specific objectives were to increase transparency and provide long-term focus to budgeting. In order to do this, the legislation provided a context that would allow advanced disclosure of budgetary impact in order to ensure independent assessment and reporting of fiscal policy. A related objective was to facilitate parliamentary scrutiny.

Three key disclosure documents were established in the law. First, a Budget Policy Statement which consisted of an early statement providing outline of broad strategic objectives for the budget, including short term intentions and long term objectives. Second, a Fiscal Strategy Report providing progress outlooks and consistency with the budget Policy Statement. Last, Economic and Fiscal Updates to take into account ongoing changes in fiscal outlook.

The legislation also established the key fiscal risk management principles. It envisaged that the fiscal forecasts had to include a statement of fiscal risks and that fiscal reports would require disclosure of fiscal risks to "the fullest extent possible". Risk disclosure is defined as all circumstances that may have a material effect on the economic and fiscal outlook. Written notification of "potential risks" is required to each Minister. Subsequently, a risk assessment is undertaken and a catalogue of risks maintained by the Ministry of Finance.

Fiscal risks are then reported in the budget documents. Baseline results in the budget plan show the agreed government policies. To adjust baselines to the best estimate of fiscal risks forecasts 'provisions' are made both in terms of the fiscal balance and the debt stock. The analysis point to highlighting key potential deviations from targets and their sources. These contingency actions and funds are then triggered during budget execution by risk materialization and ensure that budget targets can be achieved even in the presence of shocks to budget plan assumptions.

³⁴ For a detailed discussion of fiscal risk statements and risk management practices in various countries, see Cebotari and others (2009).

D. Recommendations

Short-term measures (1-6 months)

Recommendation 3.1 – *Strengthen safeguards to provide state guarantees on public enterprise loans.* This would include setting a limit in the budget on new flows of guarantees (for example 5 percent of general government revenue as in the Fund-supported program targets), charging a risk-based guarantee fees and enhancing the assessment of borrowers' ability to repay debt by the MoF Debt Management Unit when issuing such guarantees. (April 2015)

Recommendation 3.2 – *Prepare a fiscal risk assessment of SOEs.* The analysis could focus on macroeconomic risks (including exchange rate risks) and the impacts of adverse commodity prices and conflict-related factors on SOE performance and ability to repay debt as well as their ultimate budget impacts (April 2015). The document could be an input into the fiscal risk statement to be included in the budget plan later in the year (see below).

Medium-term measures (6 months to 2 years)

Recommendation 3.3 – *Prepare a fiscal risk statement on the basis of good international practices and disclose the information in the context of the budget preparation.* This should include risk mitigation actions and measures that would be triggered by materialization of risks to the budget (September 2015, in time for 2016 budget preparation).

Recommendation 3.4 – *Review the rationale for the existence of SOEs in areas where a private market exists or for non-commercial activities.* SOEs that perform general government functions could be dissolved and their activities carried out by government departments and their operations put on the budget to ensure transparency of fiscal obligations. Commercial activities such as aircraft manufacturing and operation of railway and postal services could be run in a competitive market by different agents. Where community service obligations are carried out by mainly market based entities the level of government subsidy should be explicitly recorded in the financial statements of the entity and the government budget. (September 2015)

Recommendation 3.5 – *Strengthen capacity in the economic ministries (MoE and MoF) to identify and assess fiscal risks through the use of specific analysis tools.* These should include building capacity to estimate the budgetary impact of a variety of shocks, including those originating from SOEs and contingent fiscal liabilities. Tax expenditure costs and fiscal risks should also be disclosed and assessed. The Ministry in charge of the identification and management of fiscal risks should be decided based on their economic analysis capacity (at present the greatest capacity is in the MoE). (September 2015).

Recommendation 3.6 – *Strengthen the public sector database to include more detailed information on the public sector balance sheet, including nonfinancial assets such as land and real estate (September 2015).*

IV. STRATEGY FOR MANAGEMENT AND OVERSIGHT OF STATE ASSETS

A. Background

74. **A number of reports have identified the need to improve the management and oversight of state assets.** A 2011 World Bank report³⁵ and FAD's 2014 PFM report³⁶ arrive at broadly similar conclusions, including that state asset ownership and management framework is decentralized, fragmented, and includes numerous conflicting roles and responsibilities at different levels of government. The legal framework surrounding ownership is also complex, often contradictory and is likely hampering efforts to increase transparency, put in place a coherent management framework and unblock the stalled privatization program.

75. **FAD's July 2014 report recommended prioritization of three areas in seeking to put a framework in place to manage the portfolio of state assets, unlock potential value and identify and mitigate the associated fiscal risks; reforming the legal framework; agreeing an ownership structure that would meet the objective of maximizing value, and introducing policies to ensure transparency.**

76. **Previous attempts to introduce reforms aimed at addressing underperformance and sub-optimal oversight arrangements surrounding the portfolio of state assets have not been successful.** There were many factors that contributed to these failures, not least of which was the absence of any comprehensive control over the entities that were established to manage the reform process. However, key issues were not addressed during previous efforts at reform. These include:

- a. *The absence of a consolidated ownership structure with capacity to manage a complex portfolio of corporate and other state-owned assets.* Previous efforts to manage the portfolio of state assets did not take into consideration the need for consolidated professional asset management of a hugely complex and fragmented portfolio with many owners, regulators and other stakeholders.
- b. *The absence of necessary pre-conditions to facilitate successful reform.* These included the absence of transparency and control over the assets, failure to address weaknesses in governance arrangements and the absence of a comprehensive register of assets that could be used to inform portfolio management decisions.

³⁵ "Ukraine: System of Financial Oversight and Governance of State Owned Enterprises," World Bank, 2011.

³⁶ "Public Financial Management Overview," IMF Fiscal Affairs Department TA Report; Olden et al., July 2014.

- c. *Underestimation of the importance of political buy-in at the highest level.* There is little evidence that there was an understanding or willingness at a high political level of the need to reform the sector and ensure that the responsible entities had the capacity and appropriate institutional framework in accordance with international good practices.
- d. *The absence of a communications strategy to cultivate broader support for the reform strategy.* Previous reform efforts took place in an environment of secrecy and lack of transparency and failed to win the support of the public and other stakeholders, resulting in immediate suspicion (often justifiably so) as to the motives for any moves to reform the sector. As a large employer and significant contributor to the overall economy (see Chapter III) it is understandable that the public was resistant to any changes that they saw as unlikely to result in improvements or, in some cases, could result in severe worsening of their economic situation. Government communication did little to allay these fears.

B. Draft Conceptual Strategy for Improving Efficiency of SOE Management

77. **To address many of the issues identified in Section A, in January 2015, the MoE developed a draft conceptual strategy for reform of the SOE sector.** This is an extremely encouraging development. The concept note, while high level, includes many of the elements that are needed to reform the sector and once fully developed and supported by the political leadership should form the basis for comprehensive reforms to be introduced. The draft concept note addresses the key issues required to pave the way for a more professional process and management of public commercial assets. The main principles in the note focus on:

- Improving transparency of the portfolio, articulating the objective of the reforms, and identifying the ownership unit, as well as the individual management of operation of enterprises as an area in need of address;
- Separation of the state's ownership and regulatory functions;
- Introducing value maximisation for the portfolio of state assets as well as the individual SOEs.
- Creating sufficient SOE analytical capabilities.

78. **The concept note is the first step in the process of preparing a full reform strategy for SOEs due to be completed by end-May 2015.**³⁷ The MoE also intends to improve transparency through the publication of the first of what is expected to be an "Annual Review" offering a first "best efforts" attempt at providing an overview of the portfolio in April 2015. (Appendix IV offers some suggestions for the proposed outline of the report.) The initial focus

³⁷ The concept note focused on the largest SOE and did not make any analysis of other state assets such as real estate.

will be on the largest SOEs with the intention of expanding the analysis in a second report intended to be produced in September 2015 covering all of State Assets potentially including the government's real estate portfolio. This is an excellent first step in terms of communicating the scale and importance of the portfolio to the various stakeholders, including the general public.

79. **The rest of this section seeks to highlight some issues that could be considered for inclusion in the concept note so as to better inform the main reform strategy.** These include:

- The need to acknowledge the need for a full inventory of SOEs and other state owned assets;
- The need for a stock-take of the existing legislation surrounding management of state assets;
- The need to separate commercial and policy objectives and to define SOEs in accordance with their commercial or non-commercial status;
- Incorporation and move towards an equity culture;
- A clearer view of the options in developing an ownership and management structure for the portfolio; and
- The need to include a communications strategy within the framework of the overall strategy.

A full inventory of state assets

80. **The existing concept note does not include any discussion on the need to carry out a stock-take of the existing portfolio of SOEs.** However, during discussions with the MoE, it was evident that significant work is underway to develop a database of SOEs with an initial focus on the top 100 SOEs, given they cover an estimated 90 percent of the total revenues generated by the SOE sector, based on very incomplete data.³⁸

81. **There is a need to broaden the scope of the inventory to cover all SOEs, as highlighted in Chapter III.** While it is estimated that the revenues of the top 100 SOEs covers over 90 percent of the revenues generated by the sector, it does not mean that there is little value in seeking to put a comprehensive register of SOEs in place.³⁹ There is little information available as to the underlying assets and liabilities of smaller SOEs or those deemed not to be operational or in the process of liquidation. Absence of information does not necessarily mean

³⁸ Source: MoE.

³⁹ Source: MoE.

that the firms have no value and development of a database of all SOEs with full information as to their revenues, expenses, assets, liabilities, payables and receivables should be a key objective of the conceptual strategy.

82. **A full inventory will take time to prepare and there is a political imperative to urgently produce information on those SOEs that pose the greatest fiscal risks to the budget (see Chapter III).** Therefore, the preparation of a full inventory of SOEs should be carried out on a phased basis and this process should be clearly identified in the concept note. The current plan to examine the largest SOEs should be finalized as quickly as possible in time to be included in the first report on the status of the sector⁴⁰ with a view to completing a full inventory in time for publication of the second report in September 2015.

83. **The concept note has a specific focus on SOEs, but there is also a need to incorporate management of the government's real estate portfolio.** This is currently estimated to consist of more than one million assets consequently forming a large part of the state asset portfolio. While it is understandable that the focus to date has been on reform of SOEs, given the budgetary pressures emanating from this sector, government real estate can be a source of considerable value to the government which needs to be managed professionally.

84. **Buiter⁴¹ and Tanzi⁴² stress the importance of a national register of state assets, together with comprehensive reporting to facilitate analysis of potential alternative uses for existing real estate stocks.** A balance sheet approach (see Chapter III) would enable proper incentives to develop the value of the assets, as well as helping to identify the yield to be expected from the portfolio.

85. **There is no unified register of real estate that could be used to identify the assets owned by the public.** A number of registers of land and buildings exist (see Box 8) but they are incomplete in terms of coverage.

86. **Ukraine is not unique in not having a comprehensive register of real estate,⁴³ or a complete cadastre.** However, that does not mean that it is not an important element of a comprehensive strategy to reform the management of state assets. The absence of a full inventory makes it difficult to manage these assets in a way that exploit synergies and alternative uses of public assets and unlock the value inherent in the portfolio. It also makes it difficult to

⁴⁰ The MoE intends to produce its first report on the status of SOEs by the end of April 2015.

⁴¹ "Measurement of the public sector deficit and its implications for policy evaluation and design," *IMF Staff Papers*, Buiter et al, 1983.

⁴² "The cost of government and the misuse of public funds," IMF, WP/00/180, Tanzi and Prakash, 2000.

⁴³ The few exception are countries like Sweden, Finland, and Austria that not only has a public sector balance sheet approach, but has also created dedicated holding companies for its public assets.

make informed decisions on whether to realize some of this value which could, over time, be used to fund efforts to restructure or privatize existing SOEs that may need to be recapitalized or restructured in advance of sale.

Box 8. Existing Registers of Real Estate Assets in Ukraine

Ukraine has two registers with information on real estate. The **State Land Agency of Ukraine** (SLAU) maintains a cadastre of all land plots, but this does not include details of any buildings on the land. The SLAU includes information on the technical data of the land plot, such as size, zoning etc., as well as information about ownership. However, the coverage of the register is less than 20 percent.

The **State Register of Property Rights to Real Estate** registers the ownership of buildings and land. This registrar is held by the State Register Service of Ukraine at the Ministry of Justice in order to enable an owner of a building to register and confirm its ownership title. However, this register only reflects details against which transactions have been included (i.e., purchase/sale).

With regards to public-owned real estate, **the SPF** holds a register of all state property. This register is based on the State Register of Rights to Real Estate. The detail of SPF register information is unknown; however, there is an official procedure which enables the application for such information governed by the SPF. The information is provided upon request. The database is formed in such a way that it includes both information on the legal entities holding the assets and some information on the assets owned directly by the state. According to the SPF there are around 1 million individual properties, with the majority being buildings, in the register.

Separation of commercial and non-commercial entities

87. **The concept note rightly highlights the need to separate the state's ownership and regulatory functions (albeit it is not sufficiently clear as to the options that are being considered in this regard – see below).** Line ministries should focus on development of policy and ensuring that the appropriate regulatory framework is in place to ensure orderly, fair and efficient markets for the sectors under their control.

88. **Once a full inventory of state assets has been completed, it will be necessary to perform an audit of the existing portfolio to determine whether individual entities are of a governmental or commercial nature (see Chapter III).** The concept note should incorporate this as a primary objective.

Review of the existing legislation surrounding management of state assets

89. **The legal framework itself is comprised of a range of overlapping and sometimes contradictory legislation.** The fundamental constituents of this system are the 2004 Commercial Code of Ukraine (CCU), and the 2006 Law on the Management of State Property ("State Property

Law”). However, it also includes resolutions of the Council of Ministers (CoM), as well as regulations, procedures and rules issued by the MoE, MoF, SPF, and various line ministries.⁴⁴ Additional laws govern certain SOE-dominated sectors such as railways and utilities, as well as specific assets such as pipelines, seaports, and inter-city road infrastructure.⁴⁵ (See number of laws applicable to SOEs in Table 5 and detailed list in Appendix V).

90. **Compliance with laws and regulations varies across the SOE sector.** There are significant gaps in the fulfillment of performance evaluation requirements by SOEs.⁴⁶ In some instances, legally mandated dividend remittances do not take place. Line ministries can satisfy MoF requirements by extracting large dividends from profitable SOEs, effectively exempting other SOEs within their portfolios. Even then, gaps in overall level of payment persist.⁴⁷

Table 5. Ukraine: Indicative List of Legislation Surrounding SOE Oversight and Regulation

Laws by type of SOE	Applicable laws (indicative list)
Non-incorporated state-owned proprietorships	12
<i>Kazenni</i> SOEs	7
Fully state-owned companies	9
State holding companies	3
Joint-stock corporations with state share	11

91. **The existing corporate legal code is currently overcomplicated, ambiguous, and at times internally contradictory, providing state authorities with significant latitude in determining when and how to apply it.** Businesses report high levels of corruption, with regular “inspections” by various regulatory bodies requiring bribes to continue operations.⁴⁸

92. **SOEs do not have legal ownership of assets they operate.**⁴⁹ This creates disincentives for efficient reinvestment and utilization of these assets and maintains a mechanism through which the state can exert direct control over day-to-day management. SOEs effectively only have operational use and are leasing the assets from the state.

⁴⁴ IMF, 2014.

⁴⁵ IMF, 2014.

⁴⁶ WB, 2011.

⁴⁷ WB, 2011.

⁴⁸ Government of Ukraine Report on Diagnostic Study of Governance Issues Pertaining to Corruption, the Business Climate and the Effectiveness of the Judiciary, July 2014.

⁴⁹ For example, the network and carriages of UKR Zaliznytsia (Ukraine Railways) is owned by the State not the company. Similarly, the pipelines that Naftogaz manages are the property of the State.

Separation of ownership and regulation

93. **The concept note highlights the need to separate the ownership and regulatory function of the government.** However, the options being considered to achieve this objective are not clearly spelt out.
94. **The concept note also refers to the need to explore different governance models.** It lists the Romanian “Fondul Proprietatea” as one option of the holding company model, but it does not specify some of the other models that might be considered.
95. **The July 2014 FAD report recommended the establishment of a unit in the MoF to determine and manage the risks associated with the portfolio; oversee all financial flows; and establish the portfolio’s value.** It also recommended that consideration be given to a more ambitious management structure consolidate responsibility for active ownership, financial control, and privatizations within a single arms length entity over the medium term.
96. **Since July 2014, the situation has changed and the MoE has now actively taken charge of the reform process.** This is evidenced by the fact that the MoE is now actively developing the reform strategy and has established a working group consisting of key actors in the public administration and from the private sector to help prepare the strategy and oversee its implementation.
97. **In considering the options, there are a number of models that could be considered.** Each has its advantages and disadvantages and these should be highlighted to allow for an informed debate as to the best options. The most obvious options include:
- a. *Establishing a discrete unit within the MoE (or another economic ministry such as the MoF) with responsibility for determining and managing the risks associated with the portfolio.* The unit would oversee all financial flows, establish the portfolio’s value and manage the ownership and development of portfolio with a single value maximization objective. This is the approach recommended in the July 2014 model, at least in the short-term, and has the technical advantage of being relatively easy and cheap to establish. However, the downside is that the public administration has no experience of active management of commercial assets and few of the financial analysis and portfolio management skills necessary to manage a complex portfolio of companies and assets. In addition, a unit within government would run the risk of being side-tracked from its goal of portfolio value maximization by the temptation for policy makers to use the portfolio to carry out policy objectives. In addition, existing civil service pay guidelines would make it difficult to attract people with these skills. A possible solution would be for external donors to finance the establishment of such a unit and the hiring of people with the necessary skills. However, this could only be a temporary arrangement and the risk would be that these skills would evaporate as and when such external funding ran out. Therefore, this option may be

appropriate as a short-term measure to establish the framework for managing the portfolio, but is unlikely to be an effective longer-term solution.

- b. *Establishing an external incorporated holding company and hiring professional asset managers.* This would have the advantage of putting in place managers and analysis with the relevant private sector skills of actively managing and developing the portfolio. This would serve to insulate the portfolio from political interference, particularly if the managers were clearly held accountable for the performance and consequently incentivized to maximize the value of the portfolio for the shareholder (the government). The downside to this arrangement is that efforts to do this in the past have failed, due to the absence of the necessary prerequisites including proper political insulation of the holding company, a clear objective and the proper transparency (see above) that would allow such a vehicle to achieve its objectives without being compromised by various vested interests. In seeking a ring-fenced vehicle at arm's-length from short-term political influence, it is essential that its activities are subject to rigorous scrutiny and performance assessment with concrete consequences for failure to reach performance targets, as with an asset management company in the private sector. As many of the prerequisites are not currently in place, it is likely that this option can only be seen as a more medium-term objective.
- c. *A variant of the holding company model described in (b) above, is the Romanian example, the "Fondul Proprietatea" model, where the holding company was not only listed on the local stock exchange, but also where the management was outsourced to an international professional asset management firm.* This is a variant on option (b) that has a number of attractive features including that the portfolio management expertise would be tried and tested and that the owner could demand more severe damages than what would be possible if recruiting a professional management team of individuals. However, it suffers from the same absence of the necessary prerequisites. Again, this option looks more suitable to the medium term
- d. *Establishing a series of holding companies that would manage groups of state assets in individual sectors of the economy.* This would have the advantage of allowing the manager to manage portfolios in what could be regarded as a more manageable number of assets. However, it also has a number of (possibly overwhelming) disadvantages. In the first instance, it would probably be an extremely expensive proposition requiring establishment of separate holding companies with professional management and qualified staff with the requisite skills to manage several portfolios. There is also the constraint that limited capacity already exists in the private sector expertise that could come in to question for the option (b) portfolio.⁵⁰ It would also be a return to the existing fragmented approach to

⁵⁰ Reportedly, the ministry of defense is in the process of setting up a holding company for its assets, including hotels, restaurants, shopping malls, residential buildings, service and maintenance functions, industrial production corporations etc.

management and ownership of SOEs thereby reducing possibilities for segmentation of assets across the portfolio that would extract valuable synergies and maximization of the value of the portfolio. It would be extremely difficult for the government as a shareholder to exercise oversight as it would require the introduction of a complex reporting and analysis framework to ensure that each holding company was meeting its objectives. This appears to be the least attractive option in the short or medium term.

98. **The conceptual strategy would benefit if the different options were included to promote a full debate on the appropriate option or mix of options to be considered.**

Whichever option is chosen will ultimately be decided by government, but it is important that the government is informed of the advantages and disadvantages of each of the possible solutions before any decision is made.

99. **The choice of vehicle is a direct reflection of the political reality and the amount of political will the political leadership is able to generate.** Experience of other countries informs that it is not unusual for a gradual approach to take almost a decade to fulfill as resistance builds-up instantly with the announcement of a plan to change the social contract in society. Research also shows that a “big bang” approach (i.e., creation of an arms-length holding company) requires extraordinary circumstances to convince the political leadership to take on vested interests.⁵¹

100. **Regardless of choice of vehicle, it is essential that the unit charged with owning and managing the portfolio should have an independent role with the sole objective of maximizing the value of the portfolio(s).** This would involve the establishment of a business plan for the manager as well as the individual entities that make up the platform and perform its duty as if incorporated, including putting together a consolidated business plan for all assets and proper financial accounts, audited by an international audit firm. The economic benefit of a fully integrated business plan for the entire portfolio, without constraints on necessary actions to maximize value, has important scale effects such as lower transaction and operational costs and facilitates efficient development and possible privatization of some of the portfolio, including the opportunity to merge related assets to create attractive investment profiles.

⁵¹ Olson, M. (1982) *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, (New Haven and London: Yale University Press).

Incorporation and move towards an equity based culture

101. **The concept note identifies the need to incorporate all viable SOEs as a matter of urgency.** Moving away from the current complex public sector framework and its multiple legal structures requires existing SOEs to be incorporated on the same conditions as private sector equivalents. The note should make clear that the current system whereby there are a number of management and oversight arrangements based on the legal form of the SOE should be rationalized to ensure that all commercial enterprises are managed on a similar basis and with the same reporting, auditing, and governance arrangements (see Chapter II).

102. **Efforts to introduce incorporation should be based on professional business plans that can demonstrate the viability of the entity in commercial markets.** SOEs should also have a competitive capital structure and asset base relevant to meet their business objectives. This is not currently possible and will require a new legal framework and culture of management before it can be achieved.⁵²

103. **Incorporation and assessment of company business plans could result in additional income sources for the shareholder.** Divestiture of non-core businesses and assets including off loading surplus real estate could, to a certain extent offset expected restructuring costs. Box 9 illustrates how this was achieved in Sweden's railway industry. Network industries such as energy and transportation are already examining ways of unbundling the value chain but this will prove extremely difficult in the existing legal environment.⁵³

⁵² For example, according to the management of UkreEcoResursy, the state-owned waste management entity, many of the assets they currently manage are obsolete and are not relevant to help them in meeting their business objectives. In a normal commercial environment these assets should be liquidated or otherwise disposed of, but because of the ownership ambiguity the management is not in a position to consider this option, even if it wanted to.

⁵³ This has already been announced by Naftogaz and is currently being considered by Ukraine Railways and Ukraine Post.

Box 9. Swedish Railways (SJ) – Transformation from Conglomerate to Focused Service Provider

The Swedish rail services (*SJ*) was an integrated state agency responsible for operating the railway system, receiving an annual state subsidy to cover costs for financially unprofitable operations and businesses. With no proper governance or transparency policies in place, *SJ* grew into an inefficient and unwieldy conglomerate while remaining a government agency, owning diverse assets ranging from casinos and hotels, to ships and buses, beside its core rail related operations.

In 1988, the government decided that the path to greater efficiency (and lower budgetary demands), a better service offering, and lower prices for end-users, was through liberalizing the sector and opening it up to competition. The first phase separated infrastructure from operations—forming *Banverket* (the National Rail Administration), with responsibility for all the rail infrastructure, and *SJ*, keeping the old agency brand, with responsibility for operational activities. The second phase opened both to competition, starting with local and regional traffic in 1990 and 1992, delaying to 2010 for interregional traffic. Still, Sweden was one of the first countries in Europe to largely deregulate this market.

The incorporation process did not commence until the late 1990s, and revealed an unfocused organization, unused to modern service sector requirements and with an unsustainable business model. The government decided to split *SJ* further into three separate units: for passenger and cargo services, and a third as a separate holding company consolidating all non-core operations. All three initially remained in government ownership. The initial de-coupling was intended to facilitate the individual rationalization of passenger and cargo operations, to focus on the core rail services business, and become prepared to compete with new entrants. Passenger operations retained the *SJ* brand, while cargo service was incorporated under a new brand "*Green Cargo*." Both operations recruited new management from private sector competitors. *Swedcarrier*, the holding company was charged with managing all non-core assets, and included service support functions that had to transform into neutral suppliers of these functions rather than being part of the incumbent operators.

A separate board and management were appointed to *Swedcarrier* with experience in restructuring and divestitures. The large real estate portfolio was concentrated in a separate subsidiary, *Jernhusen*, with a specialist management team charged with realizing the hidden values inherent in the portfolio. All non-core support services were sold to independent third parties, including IT services, train cleaning, train preparation services, maintenance, consultancy operations etc. Other operations sold prior to incorporation included *Swibus* (long distance bus services); a shareholding in ASG, (a road freight forwarding company), Scandlines (ferry activities); a nation-wide hotel business; and a substantial restaurant business.

Privatization process

104. **Privatizations in Ukraine have historically not proven to be very successful.** This is true whether measured on the basis of restructuring the economy, generating non-tax revenue for the budget, developing the domestic capital market, attracting foreign investors, or achievement of targeted valuations. The origins behind this failure are institutional, structural, and the implementation process. Ukrainian regulations on privatization are complex that allow for an implementation that facilitates for setting aside the competitive principles that should otherwise ensure obtaining the best price and/or most advantageous investments conditions during privatization are undermined by the several issues.

105. **Conditions imposed on potential participants in privatization often served to exclude categories of investors that might otherwise have been interested in participating.** Commitments required of potential investors were frequently so onerous that they were regarded as sufficiently daunting that potential international investors lacking domestic political leverage would balk at them, including social commitments taken literally by international investors and thereby affecting the valuations, while domestic investors would not take this face value and thereby not discount it into the price. Also very specific requirements (e.g., possessing a special license or a specific experience) with which participants from other countries or slightly different background may not be able to comply.⁵⁴ This allows the relevant authority to tailor the qualifying conditions such a way that it could easily reject all potential investors except for—"the right" buyer.

106. **Other impediments and barriers to entry into previous privatizations initiatives were also apparent.** These included lack of visibility and disclosure of relevant information on the privatization target, thereby limiting opportunities for the bidders to carry out comprehensive due diligence. Also, simply through limited publicity for the intended privatizations.⁵⁵ In addition, the criteria used in preparing the government's list of strategic SOEs which will not be subject to privatization. Lack of transparency and the rationale for their exclusion has not been clearly identified.

107. **Historically, no culture existed of appointing advisors to assist in privatizations.** This served to reduce trust of international investors in the openness of the process. The absence of

⁵⁴ An example includes the conditions imposed on potential investors in the 2013 privatization process for of UKrtelecom. These included precluding any investor with more than a 25 percent stake owned by any government, thereby preventing many major international telecom companies from participation and requiring that domestic revenue from telecom services in Ukraine to not exceed 25 percent of the participant's total Ukrainian revenue thereby excluding all domestic telecom operators.

⁵⁵ A common example was limiting announcements about specific privatizations to official governmental newspaper in the Ukrainian language, or announced on dates where the market is not likely to be engaged (such as Christmas Eve).

internationally acceptable qualification criteria, as opposed to procedures which were often deemed to be tailor-made for specific buyers also served to undermine trust in the process.

108. **The existing institutional framework surrounding privatization with a privatization agency (SPF) acting as an advisor rather than an active asset manager to the otherwise fragmented ownership, has seldom proven successful in other countries.**⁵⁶ The lack of distance from the state, the absence of capacity to address the task from a professional perspective, as well as the lack of resources to invest or develop the assets, undertake pre-privatization financing and/or ensure adequate preparations to render the assets financeable has hindered the privatization process leading to a situation where the number of transactions is now negligible and since 2009 have virtually come to a halt.

Communications strategy

109. **It is essential that the government ensure that the public is kept well informed as to the ultimate objectives of the reforms,** i.e. fiscal sustainability, maximization of the value of the portfolio for the citizens benefit as opposed to the benefit of those few with inside access, and helping to create situations where thriving and competitive markets can be established without disadvantaging other market participants.

110. **A communication strategy should be an integrated part of the reform strategy.** The concept note would benefit by including the need for a communication strategy as an essential element of the overall reform plan. A well thought out and executed communication strategy will be a critical input in promoting buy-in from the Verkhovna Rada and the general public for the extremely ambitious and complex reform efforts that are envisaged, as well as the international investor community.

C. Challenges in Implementation of the Strategy

111. **For this reform to work it is essential that all of the senior policy makers are fully supportive.** This includes the President, Prime Minister, Ministers of key economic ministries and of key pectoral ministries. Consequently, it is incumbent on the main drivers of the reform, the MoE, to ensure that all of these stakeholders are fully informed and required to make policy decisions that endorse the reform strategy and the implementation plans associated with strategy.

112. **Completing the reform process will inevitably involve up-front costs and these will have to be factored into any approved strategy.** This is likely to have budgetary implications, as it is unlikely that donors will be able or willing to bear some of the costs. These costs could

⁵⁶ For many of these reasons, the new government in Greece has announced it is closing down the HRADF, its equivalent of the SPF and consolidating ownership and privatization by merging HRADF, the General Secretary of Public Property, ETAD & Attica Riviera SPV into a new entity they call the Greek National Wealth Fund.

include, capacity building at the ownership level in individual SOEs, including the cost of retaining private sector experts such as investment banks, real estate experts, auditors, and lawyers when relevant in order to assure the best private sector standard of delivery. Some SOEs may require significant up-front investment to prepare them for privatization or to ensure that they remain viable as commercial entities within the public sector.

D. Recommendations

Short-term measures (1-6 months)

Recommendation 4.1 – *Further develop the draft concept note to include more details of the likely direction of the reform strategy for SOEs. This should include: a full inventory of SOEs and other state-owned assets; a stock-take of the existing legislation surrounding management of state assets; separation of commercial and policy objectives and defining SOEs in accordance with their commercial or non-commercial status; incorporation and moving towards an equity culture; a clearer view of the options in developing an ownership and management structure of the portfolio; and a communications strategy within the framework of the overall strategy. (March 2015)*

Recommendation 4.2 – *Include in the concept note a description of the key challenges that need to be addressed if the reform strategy is to be successful, including the need for political buy in and the need to consider upfront investment costs associated with implementation of the reform strategy. (March 2015)*

Recommendation 4.3 – *Expand the coverage of information collected by the MoE on public sector institutions to include all SOEs and all real estate. Create an inventory of SOEs and introduce a database maintenance process. Collect information on public finance operations, including revenue from sales, wages, and employment, net financial profits and losses, assets and liabilities, including wages arrears. Consolidate this information in a monitoring report of SOEs and publish the report on a timely basis. (September 2015)*

Medium-term measures (6 months to 2 years)

Recommendation 4.4 – *Review how legal title of assets currently operated by SOEs but owned by the state can be assigned to SOEs, to incentive better utilization of assets, thereby improving financial and fiscal discipline, and increasing the value and attractiveness of SOEs as potential candidates for future privatization.*

Recommendation 4.5 – *Review the role of the SPF in managing the privatization process as part of the overall reform strategy. Consideration should be given to merging the privatization role with that of the ownership role. (September 2015)*

Appendix I. Developing a Fiscal Risks Identification, Reporting and Mitigation Framework

Fiscal risks are defined as deviations of budget outcomes from plans, stemming from unanticipated shocks. These risks materialize as a result of macroeconomic shocks and realization of contingent liabilities, including the ones arising from the operations of public enterprises. Sources of fiscal risks include:

- macroeconomic shocks to real economic variables such as economic growth, interest rates, and exchange rate;
- shocks to commodity prices, such as oil and gas prices, and their impacts on the budget aggregates and the stock of public debt;
- shocks originating from calls on contingent liabilities, such as debt guarantees and implicit liabilities, including the obligation of the government in the bailout of non-viable financial and nonfinancial public institutions, and private institutions with systemic macroeconomic impacts.

Fiscal risks include effects on public finance of temporary and permanent shocks, with the former calling for fiscal policy adjustments through the operations of stabilizers and the latter requiring a more permanent correction of underlying fiscal policy to ensure debt sustainability over the medium term. Shocks may also offset each other in terms of fiscal effects, but could also be compounded thereby amplifying the budget impacts. For example, an exchange rate depreciation can also lead to higher imported inflation and to a worsened fiscal position as a result of higher expenditure, including for debt service if liabilities are foreign-exchange denominated, and lower revenue.

To gauge the extent of fiscal risks, it is essential to identify and assess the different sources of risks to the budget during preparation. The inclusion of a risk assessment would raise awareness about the size and the source of budget risks, their likely impact and expected fiscal effects, so that risk mitigation actions can be planned and put in place when needed. Risk identification and assessment typically goes beyond the direct impact of shocks on the budget outcomes, to include the analysis of indirect effects of shocks. For example, in countries where public enterprises are a significant source of fiscal risks, as in the case of Ukraine, indirect budget impacts of macroeconomic shocks on SOEs finances (which could eventually affect the budget through the need to recapitalize or subsidize loss-making entities) would need to be taken into account. Full disclosure of fiscal risks helps create a transparent discussion of fiscal policy and its risks over the short and medium term at the time of the budget preparation. It can also inform decisions about the fiscal policy stance and fiscal reforms to help eliminate or limit the occurrence of budget risks and, in case this is beyond the control of the authorities, minimize their impact on fiscal outcomes.

Macroeconomic shocks are typically one of the most important sources of fiscal risks. They stem from deviations of macroeconomic outcomes from plans and affect the budget directly and indirectly via the operations of entities that are linked to the general government budget, such as public enterprises and financial institutions. Deviations of fiscal outcomes from expectations may reflect weak forecasting capacity for the main macroeconomic variables. In many countries, economic growth forecasts tend to be biased in favor of optimism, thereby providing a favorable picture of revenue performance in the budget and financial performance of public sector entities.

When economic growth realization is lower than forecast, budget outcomes tend to be weaker than planned. In this context, key fiscal indicators (such as the ratio of public debt and fiscal deficit to GDP) worsen, and the performance of the SOE sector weakens. Also, deviations between actual and expected growth levels may lead to higher unemployment, worsened social indicators, including the increase of the population at-risk of poverty, calling for higher social expenditure and the operation of automatic stabilizers. These may put financial pressure on the budget and increase borrowing cost. This, in turn, may lead to compound shocks to other economic variables including interest rates on government securities and inflation, which may further worsen the fiscal position.

Unanticipated movements in the exchange rate are a more significant source of risks for the budget and the public sector. Large changes in exchange rate levels compared to budget expectations may cause direct effects on the budget, particularly for countries that are either exporters or importers of foreign-exchange denominated commodities, goods, and services. Exchange rate depreciation, for example, makes imported goods and services more expensive, could put pressure on price inflation and affects the budget through the tax system and public expenditures linked to prices through indexation, including wages and social benefits. Typically, these shocks tend to be large and are associated with significant worsening of key fiscal indicators.

Changes in exchange rate as compared to those used to prepare budget plans can also affect the operations of SOEs with a large share of their business devoted to exports or imports. Moreover, when assets and liabilities of public sector institutions are denominated in part or fully in foreign currency, exchange rate deviations may generate pressure on debt service payment capacity and increase the value of liabilities in local currency, in some cases leading to unsustainable financial conditions. These shocks can also trigger calls on contingent liabilities, such as SOE loans guaranteed by the state, or make recapitalization of loss-making public sector companies that provide critical public services necessary. This could affect debt sustainability of the general government and lead to a fiscal crisis, unless adequate preventive measures and contingencies have been put in place in the budget.

Commodity price shocks can lead to substantial public finance impacts. In commodity exporting economies, these shocks are associated with lower growth, reduced inflows of foreign currency and loss of international market shares. These effects could have both short term and

more permanent effects on fiscal sustainability and may require sizable corrections of the fiscal position. In commodity importing economies, sharp commodity price adjustments may lead to insufficient access to key production inputs, affecting economic growth and thereby the budget outcomes. They would also alter the relative price ratios of tradeable goods and could lead to higher consumer prices for provision of utilities and other services, as in the case of oil, gas and food prices.

Distributive implications can also be important. In particular, subsidy costs may rise as a result of these shocks, thereby encouraging budget resources to be reallocated towards these programs and limiting the scope for targeted social safety nets. Moreover, the poor may be most affected by an increase in prices of basic services, putting pressure on the budget to compensate for these effects. Finally, public sector companies may suffer losses resulting from higher input prices, slower economic growth, and inflationary pressures.

Financial variables, including unanticipated shocks to interest rates, can also be important sources of fiscal risks. Interest rate shocks may affect debt service payment capacity of the government and the SOE sector, make access to financing more difficult and expensive, and reduce economic growth through higher cost of capital for investors. Changes in interest rates can also lead to balance sheet effects, both in the general government budget and for public enterprises, increasing the likelihood that government guarantees are triggered as the cost of servicing loans becomes unsustainable.

A lack of understanding of the size of the public sector may result in unforeseen obligations for the budget. Incomplete coverage of entities outside the general government, but within the public sector that have the potential to impact on the budget is a frequent source of such unforeseen obligations. When the public sector information system is limited to a subset of institutions and companies which have relations with the budget, additional risks may arise when unanticipated obligations of entities under government control (but beyond the general government perimeter) affect the budget. This is particularly important for SOEs, as the recent experiences in many crisis-affected countries such as Portugal and Greece have borne out. Partial coverage in fiscal accounts and other public sector reports documents may cloud important sources of budget risks and undermine the risk mitigation strategy.

Appendix II. Contents of Fiscal Risk Statements

Fiscal risk statements are typically documents containing information on budget risks from a variety of shocks. The document could be either a separate note to be prepared with the budget documentation or embedded in a section of the budget document. The document contains an analysis of the sensitivity of budget estimates and public debt projections to key macroeconomic assumptions, and a range of contingent fiscal liabilities, including from SOEs. The sources of risks included in the document in general depend on the relative size of the fiscal risks, the likelihood of the event, and the availability of information to allow a risks assessment exercise.

While in principle all fiscal risks should be disclosed, it is standard practice to limit the type of budget risks assessed in the document. The document has to strike a balance between the benefit of releasing information on budget risks and their effects in a comprehensive manner and the need to minimize or avoid moral hazard. This implies communicating budget policy objectives and uncertainty surrounding the budget in an adequate way that would not disrupt market confidence and can enhance fiscal policy credibility. For example, the disclosure of contingent liabilities should be crafted carefully in order to avoid providing the impression that implicit guarantees especially to the financial sector should be considered as unconditional underwriting of future financial liabilities.

Fiscal risks statements usually contain information on risk mitigation actions. These may include budget contingencies set aside to cushion the budget from the adverse impact of negative shocks, risk sharing mechanisms that would minimize the budget impact of negative scenarios, and automatic stabilizers that would be in place when risks materialize. Prudent macroeconomic assumptions in the budget formulation stage are a key element of a strategy to minimize risk occurrence and their impact on the budget. The preparation of the fiscal risk document and the associated risk mitigation strategy is generally the task of a central authority in the government, with the necessary authority and accountability to identify risks, monitor them, and propose remedial actions.

While there is no standard document to be used for fiscal risk statements, there are general elements of it that have emerged in international good practices. The fiscal risk statement should be adapted to country circumstances and the specific fiscal risks that are relevant for the economy and the government budget on the basis of the structural and institutional characteristics of each country. Nonetheless, there are some general recommendations that could be useful to bear in mind in the preparation of fiscal risk statements on the basis of a decade-long international experience with these documents. Based on these best practices a statement of fiscal risks could contain the following information:

- *Macroeconomic risks and budget sensitivity:* This includes a discussion of macroeconomic forecasting accuracy in the past and sensitivity analysis of budget estimates to changes in

individual macroeconomic assumptions and combination of the latter in a scenario. In addition, a presentation of fan chart with uncertainty surrounding budget estimates could also be included.

- **Public debt:** This covers the sensitivity analysis of public debt dynamics to alternative scenarios of macroeconomic variables and underlying contingent risks. Both ratios of public debt to GDP and debt service indicators could be reported and a disaggregation of debt dynamics into its fiscal policy and macroeconomic variable components could be added.
- **Contingent liabilities:** These could be disclosed presenting the face value of the portfolio of guarantees, such as loan guarantees to public enterprises, as well as scenarios to assess the likely cost to the budget in case guarantees are called on the basis of an ex ante probability distribution. Banking sector risks, budget impacts from natural events and disasters, and fiscal obligations stemming from public-private partnerships could also be reported both as face values and expected losses.
- **SOEs:** The document could include a description of the policy framework for SOEs, including pricing policy, dividend policy, and subsidies. It could also include the financial position of the consolidated sector and of the largest (or riskiest) public enterprises. An analysis of sensitivity of key financial indicators of SOE performance, including net losses and borrowing needs, under alternative scenarios could be added to the fiscal risk statement, along with an assessment of the likely impact on budget aggregates and public sector liabilities indicators.
- **Risk mitigation:** This section of the document describes the risk management strategy and the specific actions planned to limit the impact on the budget of adverse shocks identified in the previous sections of the fiscal risk statement in the case they materialize.

Examples of fiscal risk statements include the documents produce by the ministries of finance in Australia and the Philippines. They contain information of fiscal risks as well as actions to mitigate these risks, which comprise automatic measures triggered by shocks, contingency funds, and provisions to adjust fiscal policy parameters in the case of shocks.

Appendix III. Outstanding State Guarantees on SOE Debt as at end-2014

Creditor	Borrower	Project covered by the loan/credit	Currency	Amount CCY	Amount UAH ¹
1	2	3	4	5	6
2004					8,366,584,000
EBRD	Ukrzaliznytsya (UZ)	High-speed passenger trains	USD	120,000,000	637,416,000
EBRD	Energoatom	Nuclear plants	USD	42,000,000	223,720,000
European Atomic Energy Community	Energoatom	Nuclear plants	USD	83,000,000	441,228,000
Credit Suisse First Boston	Yanhel Yuzhnyi SDB	Cyclone-4 project	USD	150,000,000	795,930,000
Maglin Capital Limited	UZ	Road bridge	USD	700,000,000	3,714,690,000
Deutsche Bank AG London	Ukravtodor	Kyiv-Odessa highway	USD	480,000,000	2,553,600,000
2005					661,063,100
EBRD	State Enterprise - National Power Company "Ukrenergo"	High-voltage transmission line in the Odessa region	EUR	25,755,133	156,063,100
Deutsche Bank AG London	Ukravtodor	Kyiv-Odessa highway	USD	100,000,000	505,000,000
2006					3,520,578,289
EBRD	Ukreximbank	Export development project	USD	154,500,000	780,225,000
Citibank, N.A. London	Ukravtodor	Public roads	EUR	279,886,635	1,740,353,289
SMI Bonds	State Mortgage Institution	Liquidity	UAH	1,000,000,000	1,000,000,000
2007					5,891,795,600
Morgan Stanley Bank International Limited	Ukravtodor	Public roads	USD	465,000,000	2,348,250,000
		Public roads	USD	465,000,000	2,348,250,000

Creditor	Borrower	Project covered by the loan/credit	Currency	Amount CCY	Amount UAH¹
EBRD	Illichivsk Maritime Commercial Port SE	Illichivsk Maritime Commercial Port	EUR	26,000,000	195,295,600
SMI Bonds	SMI	Liquidity	UAH	1,000,000,000	1,000,000,000
2008					1,000,000,000
SMI Bonds	SMI	Liquidity	UAH	1,000,000,000	1,000,000,000
2009					32,110,451,858
Canadian export agency	Ukrkosmos SE	National satellite communications system	USD	292,433,560	2,333,795,269
Credit Suisse International	Ukravtodor	Refinancing Agreement	USD	465,000,000	3,580,500,000
Credit Suisse International	JSC NJSC Naftogaz	Naftogaz Ukraine Credit Agreement	USD	300,000	2,404,440
Ukreximbank	Ukravtodor	Working capital increase	UAH	2,100,000,000	2,100,000,000
Ukreximbank	Ukrmedpostach SE	Health care equipment, vehicles, medical supplies and drugs	EUR	17,000,000	200,469,474
Bonds of Kharkiv State Aviation Production Enterprise	Kharkiv State Aviation Production Enterprise	Research and development	UAH	1,620,000,000	1,620,000,000
Ukravtodor Bills	Ukravtodor	Payments to contractors	UAH	1,619,564,451	1,619,564,451
Bonds of Kyiv Aviation Plant "Aviant"	Kyiv Aviation Plant "Aviant" SE	Research and development	UAH	858,000,000	858,000,000
Bonds of JSC NJSC Naftogaz	JSC NJSC Naftogaz	Restructuring of external debt	USD	1,595,017,000	12,783,742,252
PJSC Oshchadbank	Ukravtodor	Working capital increase	UAH	737,202,173	737,202,173
PJSC Oshchadbank	Ukravtodor	Working capital increase	UAH	980,000,000	980,000,000
PJSC Oshchadbank	JSC NJSC Naftogaz	JSC NJSC Naftogaz of Ukraine	UAH	3,691,756,530	3,691,756,530
AQUASAFETY INVEST PLC	Lviv ODPZ SE	Flood control facilities in Lviv region	EUR	50,000,000	600,669,900
UniCredit Bank Austria AG	Ukrmedpostach SE	Health care equipment, vehicles, medical supplies and drugs	EUR	85,000,000	1,002,347,370

Creditor	Borrower	Project covered by the loan/credit	Currency	Amount CCY	Amount UAH¹
2010					10,074,258,180
Bonds of FININPRO SE	FININPRO SE	2012 European Football Cup infrastructure	USD	568,000,000	4,497,821,600
VTB Capital PLC	Ukravtodor	Financing of current operations	USD	440,800,000	3,499,378,960
Export-Import Bank of Korea	Southern Railway	Purchase high-speed inter-regional trains	USD	260,950,000	2,077,057,620
2011					12,842,172,100
Bonds of FININPRO SE	FININPRO SE	2012 European Football Cup infrastructure	USD	690,000,000	5,496,126,000
Sberbank of Russia	Ukravtodor	Road maintenance	USD	376,000,000.0	2,997,133,600
Sberbank of Russia	Yanhel Yuzhnyi SDB	Cyclone-4 project	USD	260,000,000.0	2,073,682,000
EBRD	Ukreximbank	Energy Efficiency Project	USD	200,000,000.0	1,596,140,000
State Development Bank of China	PJSC "Lisichanskvugillya	Upgrading Melnikov coal mine	USD	85,000,000.0	679,090,500
2012					75,349,704,679
EBRD	Ukreximbank	Second Export Development Project	USD	150,000,000.0	1,198,455,000
SMI Bonds	SMI	Liquidity	UAH	2,000,000,000	2,000,000,000
Bonds of FININPRO SE	FININPRO SE	2012 European Football Cup infrastructure	USD	550,000,000	4,396,150,000
State Development Bank of China	JSC NJSC Naftogaz of Ukraine	Substitution of natural gas for domestic coal	USD	3,656,000,000	29,222,408,000
Exim Bank of China	State Food and Grain Corporation	Purchase of agricultural products by the borrower	USD	1,500,000,000	11,989,500,000
Exim Bank of China	State Food and Grain Corporation of Ukraine	Chinese supplier's export credit	USD	1,500,000,000	11,989,500,000
Deutsche Bank AG Schaft	Ukrtransgaz Company	"Bar" compressor station at "Soyuz" pipeline	EUR	53,574,689	553,691,679
Ukravtodor Bills	Ukravtodor	Public roads	UAH	14,000,000,000	14,000,000,000

Creditor	Borrower	Project covered by the loan/credit	Currency	Amount CCY	Amount UAH¹
2013					21,897,517,549
Ukravtodor Bills	Ukravtodor	Public roads	UAH	5,000,000,000	5,000,000,000
PJSC Oshchadbank	The Ministry of Energy and Coal Industry	Dniester PSP	UAH	1,500,000,000	1,500,000,000
PJSB Ukgazbank	Department of Energy, Transport and Communications, Vinnitsa City Council	Update rolling stock of the bus and trolley fleet	UAH	113,500,000	113,500,000
SMI Bonds	SMI	Liquidity	UAH	5,000,000,000	5,000,000,000
Bonds of JSC NJSC Naftogaz	JSC NJSC Naftogaz	Repayment of debt, bonds of JSC Naftogaz	UAH	4,800,000,000	4,800,000,000
PJSC Oshchadbank	National Agency for preparation and holding the finals of the 2012 European Football Cup	National Children's Specialized Hospital Okhmatdyt	UAH	644,274,031	644,274,031
PJSB Ukgazbank	Capital Construction Department of Kherson City Council	Building of an overpass in Kherson	UAH	198,843,518	198,843,518
PJSB Ukgazbank	Department of Capital Construction, Vinnitsa City Council	Construction of a tram line in Vinnitsa	UAH	36,400,000	36,400,000
PJSB Ukgazbank	State Agency for Investment and National Projects of Ukraine	Educational equipment for schools	UAH	608,000,000	608,000,000
OJSC Gazprombank	JSC NJSC Naftogaz	Working capital injection	USD	500,000,000	3,996,500,000
2014					0

1/ UAH equivalent is calculated based on the effective date of the contract

Appendix IV. SOE Annual Report Content: Proposed Structure and Content

1. **Foreword: by the President**, (*highlighting the importance for the country and to unite public support*)
2. **Introduction:** by the Prime Minister, explaining the main goal and targets (*to demonstrate unity of purpose in reforming the sector across government*)
3. **At a glance:** Summary of financial indicators including:
 - 3.1. *market value vs yield and dividend,*
 - 3.2. *revenue, operating profit, EBITDA, profit before tax, net profit, return on equity, gross investments, number of employees etc.*
4. **The portfolio of state commercial assets:** describing the portfolio commensurate to a privately held assets portfolio to include; structure, purpose, such as introduction of an equity culture etc.
5. **Overview of the financial results of the portfolio:**
 - 5.1 General information (*breakdown of, major sectors, vision, strategy with ownership in that sector and market analysis, as well as key developments/events which impacted the results*)
 - 5.2 Summary Financial Statements of the portfolio (*aggregated Balance Sheet and Income Statement*)
 - 5.3 Overview of value drivers (*key drivers of change in current period vs. prior one*).
 - 5.3.1 *Market value: how to create value?*
 - 5.3.2 *Operational strategy: including revenue and profit, profitability.*
 - 5.3.3 *Capital structure strategy: including debt/equity ratio, dividend policy*
 - 5.3.4 *Business development strategy: including focus on core business, liquidating obsolete assets, real estate strategy.*

6. **Overview of the financial results of by industry sector:**

- 6.1 Industry sector overview- (*Background: vision, strategy with ownership in that sector and market analysis, major competitors, as well as key developments/events which impacted the results*)
- 6.2 Aggregate sector financial statements (*aggregated Balance Sheet and Income Statement for the portfolio of each sector/sub-sector*).
- 6.3 Gap analysis with private sector (*market value, capital structure and operational efficiency*).
- 6.4 Strategic view on potential performance improvement and value optimization

7. **Major units in brief** (one page snapshots covering individual performance of selected SOEs):

- 7.1 Operations details (*business overview, key transactions, products, markets etc.*).
- 7.2 Market, objectives and achievements and goals
- 7.3 Financial performance, including dividends
- 7.4 Management (top management details).

8. **Introduction of the reform to SOE sector** (*prerequisite of reforms, summary of ongoing and planned reforms etc.*).

9. **SOE regulatory environment** (*summary of the governance structure, reporting requirements, legislation etc.*).

10. **Other countries' SOE reform experiences** (*success stories of selected economies in implementation of SOE reforms*).

11. **List of SOEs** (*company name, percent of state ownership, industry sector etc.*).

12. **Notes on methodology/approach to compilation of SOE financial information, valuation methodology.**

Appendix V. SOE Legal Framework and Regulations

A. General Laws (Applicable to all SOEs)

1. Law of Ukraine. "On Privatization of State Property."
2. Law of Ukraine "On Property." 7 February, 1991. #697-XII. (last amended: 21 January, 1995).
3. Law of Ukraine "On Enterprises in Ukraine." Last amended: February 7, 2002.
4. Law of Ukraine "On List of State-Owned Legal Entities, That Are not Subjects to Privatization." July 7, 1992 (last amended: February 7, 2002). #847-XIV. Annex: List of State-Owned Legal Entities, That Are not Subjects to Privatization.
5. Law of Ukraine "On Companies," September 19, 1991 (last amended: March 7, 2002). #1576-XII.

B. Laws Applying to Non-incorporated State-Owned Proprietorships

1. Law of Ukraine "On Property." 7 February, 1991. #697-XII. (last amended: 21 January, 1995).
2. Law of Ukraine "On Enterprises in Ukraine." Last amended: February 7, 2002.
3. Law of Ukraine. July 7, 1992 (last amended: February 7, 2002). #847-XIV "On List of State-Owned Legal Entities, That are not Subjects to Privatization." Annex: List of State-Owned Legal Entities, That are not Subjects to Privatization.
4. Cabinet of Ministers. Decree. 15 December, 1992. #8-92. "On Management of National Property."
5. Cabinet of Ministers. Resolution. 19 March, 1993. #203 (last amended: 25 July, 2001). "On Application of Contract with Head of State-Owned Enterprise."
6. Cabinet of Ministers. Decree. 10 May, 1993. #48-93. "On Order of Income Disposal of State Enterprises, Establishments and Organizations."
7. Cabinet of Ministers. Resolution. May 19, 1999. #859. "On Conditions and Amounts of Wages for Heads of State and Communal Enterprises and Mergers of State Enterprises."
8. Cabinet of Ministers. Resolution. August 2, 1995 (last amended: July, 26, 2001). #597. "On Typical Form of Contract with Head of Non-Incorporated SOE." Annex: Typical Form of Contract with Head of Non-Incorporated SOE.
9. Ministry of Economy, Ministry of Labor and Ministry of Finance, State Property Fund of Ukraine. "Typical Statute of Non-Incorporated State-Owned Proprietorship." May 10, 1993. #43.
10. Ministry of Economy. Decree. December 25, 2000. #277. "On Approval of Regulations towards Order of Annual Financial Plan Composition by SOE." Annex: Financial Plan of SOE.
11. Ministry of Industrial Policy of Ukraine. Decree. 26 July, 1999. #272. "Order of Contract Approval with Heads of Non-Incorporated , Kazenni and Communal SOEs and Their Mergers, That Are Subordinated to the Ministry of Industrial Policy."

12. Ministry of Industrial Policy of Ukraine. Decree. 28 March, 2002. #138. "On Amendments to Form of Contract with Heads of Companies, Organizations and Establishments."

C. Laws Applying to Kazenni SOEs

1. Law of Ukraine "On Enterprises in Ukraine". Last amended: February 7, 2002.
2. Cabinet of Ministers. Resolution. 22 July, 1998. #1129. "On Some Issues of Management of Kazenni State-Owned Proprietorships." Annex: Form of Financial Plan for Kazenni State-Owned Proprietorship).
3. Cabinet of Ministers. Resolution. 30 June, 1998. #987 (last amended: October 15, 2001). "On Conversion of Non-Incorporated SOEs into Kazenni SOEs." Annex: List of SOEs, which are to be converted into Kazenni SOEs.
4. Cabinet of Ministers. Resolution. 18 June, 1998. #914. "On Typical Charter of Kazenni State-owned Proprietorship." Annex: Typical Form of Charter of Kazenni State-Owned Proprietorship.
5. Ministry of Industrial Policy of Ukraine. Decree. 12 October, 1998. #371. "On Approval of Contract Form with Head of Kazenni State-Owned Proprietorship." Annex: Form of Contract with Head of Kazenni State-Owned Proprietorship; Form of Report of Head of Kazenni State-Owned Proprietorship.
6. Ministry of Industrial Policy of Ukraine. Decree. 28 March, 2002. #138. "On Amendments to Form of Contract with Heads of Companies, Organizations and Establishments."
7. Ministry of Industrial Policy of Ukraine. Decree. 26 July, 1999. #272. "Order of Contract Approval with Heads of Partially, Kazenni and Communal SOEs and their Mergers, That are Subordinated to the Ministry of Industrial Policy."

D. Laws Applying to Fully State-Owned Companies

1. Law of Ukraine "On Companies," September 19, 1991 (last amended: March 7, 2002). #1576-XII.
2. Presidential Decree June 15, 1993 (last amended: August 28, 2001). #210/93. "On Incorporating of Companies."
3. Presidential Decree "On Drastic Measures on Ordering of Activities of Fully State-Owned Corporations and State Holding Companies", November 7, 2001. #1049/2001. Annex: List of Fully State Owned Corporations and State Holding Companies.
4. Cabinet of Ministers. Resolution. 5 July, 1993. #508 (last amended: 22 April, 1997). "On Approval of Regulations towards Order of Incorporating of Companies."
5. Cabinet of Ministers. Resolution. 19 July, 1993. #556 (last amended: 7 February, 2001). "On Approval of Regulations towards Board of Directors."
6. State Property Fund of Ukraine. Order. April 6, 2000 (last amended: June 15, 2001). #695. "On Approval of Regulations towards Order of Negotiation or Re-negotiation of Contract with CEO of Open Joint Stock Company, Holding Company and Fully State-Owned

corporation and Typical Form of Contract with CEO". Annex: Typical Form of Contract with CEO.

7. State Property Fund of Ukraine. Ministry of Economy of Ukraine. Order. June 25, 2001 (last amended: October 15, 2001). #1129/134. "On Approval of Typical Charter of Open Joint Stock Company, Created by Incorporating of State Enterprise, Not Subject to Privatization." Annex: Typical Charter of Fully State-Owned Corporation."

8. State Property Fund of Ukraine. Order February 21, 2002. #343. "On Approval of Form of Financial Plan of Corporation, More Than 50% of Shares of Which Is Owned by State and Methodological Recommendations on Order of Composition and Approval of Annual Financial Plan." Annex: Financial Plan of Corporation, More Than 50% of Shares of Which Is Owned by State.

9. Ministry of Finance. Order. August 21, 1996. #172. "On Approval of Order of Inflow to Budget of Dividends from State-Owned Shares."

E. Laws Applying to State Holding Companies

1. Law of Ukraine "On Companies", September 19, 1991 (last amended: March 7, 2002). #1576-XII.

2. Presidential Decree "On Drastic Measures on Ordering of Activities of Fully State-Owned Corporations and State Holding Companies", November 7, 2001. #1049/2001. Annex: List of Fully State Owned Corporations and State Holding Companies.

3. Presidential Decree "On Holding Companies, That Are Created Through Incorporating and Privatization", May 11, 1994. #224/04.

F. Laws Applying to Joint-Stock Corporations with State Share

1. Law of Ukraine "On Companies", September 19, 1991 (last amended: March 7, 2002). #1576-XII.

2. Presidential Decree "On Drastic Measures on Speeding the Privatization in Ukraine," December 29, 1999 (last amended: December 25, 2000). #1374/2000.

3. Cabinet of Ministers. Resolution. 3 June, 1999. #951 (last amended: 29 November, 2001). "On Delegation of Rights to Manage State Corporate Shares to Cabinet of Ministers of Crimean Autonomous Republic, Ministries and Other Central and Local Executive Bodies". Annex: Lists of Corporations with State Shares, Rights of Management for Which Are Delegated to Certain Ministries.

4. Cabinet of Ministers. Resolution. 15 June, 2000. #791 (last amended: 16 May, 2000). "On Management of State Corporate Rights". Annex: Report of Authorized Representative.

5. State Property Fund of Ukraine. Order. May 24, 2000. #1065. "On Approval of Typical Form of Contract of Delegation of Rights to Manage State Shares." Annex: Typical Form of Contract of Delegation of Rights to Manage State Shares.

6. State Property Fund of Ukraine. Order. May 25, 2000. #1067. "On Approval of Typical General Agreement on Delegation of Rights to Manage State Shares to State Executive Bodies."
7. State Property Fund of Ukraine. Order. May 29, 2000. #1109. "On Approval of Instruction on Order of Report Filling-Out by Representative of Body, Authorized to Manage State Corporate Shares."
8. State Property Fund of Ukraine. Order. August 7, 2000. #1647. "On Approval of Typical Contract of Delegation of Management of State Corporate Rights to an Authorized Entity."
9. State Property Fund of Ukraine. Ministry of Economy. Order. October 20, 2000. #227/2181. "On Approval of Criteria, Upon Which Open Joint Stock Companies Are Recommended to be Classified As of Regional Importance."
10. State Property Fund of Ukraine. Order. September 11, 2001. #1647. "On Approval of Typical Contract of Delegation of Management of State Corporate Rights to an SPFU Representative."
11. State Property Fund of Ukraine. Order. May 4, 2001. #781. "On Corporate Dividend Policy."