Global Relations | Key Policy Insights

State-Owned Enterprise Reform in the Hydrocarbons Sector in Ukraine

CONTEXT

The state-owned oil and gas company Naftogaz is one of the largest and most strategically important concerns in Ukraine. It plays a critical role in ensuring the delivery of gas to firms and households, but it has long faced considerable challenges recuperating losses both from the unpaid debts of rent-seeking intermediaries and from inadequate compensation mechanisms for rendering such services. As the main gas producer in Ukraine, Naftogaz must also help meet the ambitious objectives set by the government for increased domestic gas production and its operations have a huge impact on state finances. At the same time, uncertainties regarding the future of gas transit routes through Ukraine and the threat posed by Russian-backed gas transit projects intended to reduce its reliance on Ukrainian routes, are risks that must be mitigated to protect the value of Ukraine's hydrocarbons assets and ensure energy security for Ukraine and the EU. The OECD *review of state-owned enterprise reform in the Ukrainian hydrocarbons sector*, carried out with the financial support of the Government of Norway, supports the government in its efforts to reform corporate governance in the national hydrocarbon sector in the context of the ongoing reform of Naftogaz.

MAIN ACHIEVEMENTS

The *OECD Review on State-Owned Enterprise Reform in the Hydrocarbons Sector in Ukraine* finds that the government has undertaken constructive steps over the past few years to strengthen corporate governance and transparency while embarking on an ambitious reform programme to support the transformation of the gas sector. These reforms include:

- ✓ Enacting the Natural Gas Market Law, which aimed to facilitate the implementation of the Third energy Package and other elements of the EU *acquis,* and introducing transparent public service obligation (PSO) regime for categories of protected consumers; with plans to align gas prices with the market.
- ✓ Specifying a gas transit operator as part of its unbundling and certification requirements, while also introducing opportunities for more investment and private participation in the energy sector.
- ✓ Transforming the corporate governance of Naftogaz, including establishing the first-ever independent supervisory board using as a benchmark the *OECD Guidelines on Corporate Governance of SOEs*.
- ✓ Progressive upgrading of the SOE corporate governance frameworks, including independent board requirements and external independent audit; annual aggregate reporting by the state-owner; passing a long-awaiting privatisation law; and professionalising board nomination practices.

Although these transformations have faced hurdles, the success of Naftogaz could be an important driver in the reform of the overall SOE sector in Ukraine. Given the importance of Naftogaz in the Ukrainian economy, its improved governance and performance can have far-reaching effects in all segments of the society, affecting the day-to-day lives of citizens, and other parts of the business sector. Consequently, its good governance is critical to ensure its positive contribution to economic efficiency, competitiveness and energy security.

ROADMAP FOR SOE GOVERNANCE REFORM IN THE HYDROCARBONS SECTOR

Despite the important reforms implemented to date, the OECD report also observes that the pace of reforms has slowed and that the appetite for reform in some quarters seems to have waned. Going forward, reforms should be irreversible and should result in concrete and visible changes. The OECD Review has identified 16 detailed recommendations in line with *OECD Guidelines on Corporate Governance of SOEs*. They focus on:

- ✓ efforts to strengthen the state's ability to professionally and effectively exercise its ownership rights;
- ✓ continuing to improve corporate governance practices within the company, by empowering the independent supervisory board; and
- ✓ shielding Naftogaz and other SOEs in the sector from undue political interference.

Furthermore, Ukraine cannot realise the full benefits of improved governance without addressing corruption and integrity risks in the sector, including in gas distribution and supply, as well as in licensing.

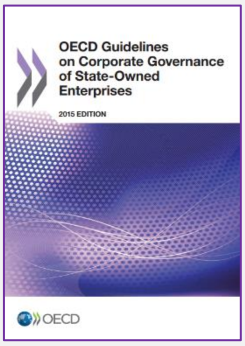
Responsibilities of the Board of Directors of Naftogaz

The Supervisory Board of Naftogaz is not adequately empowered to make key decisions according to international best practices.

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

Source: OECD, *State-Owned Enterprise Reform in the Hydrocarbons Sector in Ukraine*.

ABOUT THE OECD GUIDELINES ON CORPORATE GOVERNANCE OF SOEs



The OECD Guidelines on Corporate Governance of State-Owned Enterprises give concrete advice to countries on how to manage more effectively their responsibilities as company owners, thus helping to make state-owned enterprises more competitive, efficient and transparent.

A growing number of countries have taken steps to implement the Guidelines and refer to them in the development of regulations, corporate governance arrangements and ownership policies. The Guidelines can serve as a national reform driver by aligning practices with international standards while anchoring them according to generally accepted best practices.

The OECD Working Party on State-Ownership and Privatisation Practices provides a setting where countries can take in the shared and national experiences of OECD and partner countries and benefit from peer reviews to support reforms. Countries that associate themselves with the Guidelines must go through a review process evaluating corporate governance and regulatory frameworks using the SOE Guidelines as a benchmark.

UKRAINE AND THE OECD

The OECD supports energy sector reforms in Ukraine focusing on competition, investment, anti-corruption and corporate governance of SOEs. The work is financed by the Government of Norway and falls under the recently renewed OECD-Ukraine Action Plan to implement the Memorandum of Understanding between the Government of Ukraine and the OECD.

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