

RESOURCE GOVERNANCE INDEX 2017

«Home Work»
for Ukraine

Among the key project objectives – information support of amending the legislation on subsoil use by means of increasing awareness of the parliament for the need to adopt the draft law on ensuring transparency in extractive industries, based on relevant findings of the RGI 2017, and also promotion of reforms’ recommendations identified in a road map based on the RGI 2017 findings.

The study has been developed with support of the Natural Resource Governance Institute within the project “Increasing Transparency in the Extractive Sector through Promoting Legislative and Administrative Reforms in Ukraine”. The project is being implemented by DiXi Group. The views and interpretations expressed in this report belong to the authors and do not necessarily reflect those of the Natural Resource Governance Institute.

SUMMARY

The Resource Governance Index (RGI) measures and evaluates the quality of governance in oil&gas and mining sectors in 81 countries which are resource-rich or have such potential. Ukraine was fortunate to be included in the RGI for the first time, standing among three European countries along with the United Kingdom and Norway. However, not very successful 49 out of 100 points allowed Ukraine to take only 44th place among 89 in the ranking.

We considered RGI primarily as a tool which allows to diagnose main «diseases» and warning «symptoms» in subsoil use, fiscal management, budget planning, financial reporting, state-owned companies governance, open data and more, which is the basis for good governance of natural resources. That is why we did not take into account «Enabling Environment» as the RGI component which affects wider range of conditions for doing business – issues concerning the fight against corruption, political sustainability and conflict control, democracy development, rule of law, quality of regulation and open data environment.

As it turned out, the key gaps in resource governance take place in the following areas:

- *requirements and practice of contract disclosure, e.g. any agreements which allow to explore natural resources;*
- *requirements and practice of reporting and audits in accordance with the international financial reports standards;*
- *procedure of environmental impact assessment and environmental mitigation;*
- *land use and practice of compensation in case of forced alienation or resettlement;*
- *accountability of state-owned companies about non-operational activities and assets and also related spending;*
- *operation of a single governmental data portal with the data about reserves, production and exports of natural resources;*
- *medium-term budgeting which is necessary due to volatility of prices on energy resources and respective revenues;*
- *requirements and practice of targeted revenue sharing from extractive sector in favor of subnational budgets.*

Addressing these challenges can only be a complex one. However, considering the lack of a complex plan for subsoil use reform and «champions» in the public sector who are ready to take the responsibility for its implementation, there are several legislative initiatives which can radically change the situation for the better. They are targeted at specific yet very effective changes in the issues of land use, environmental impact assessment, budget planning, public finance management and information disclosure.

Among them – the draft law «On Ensuring Transparency in Extractive Industries» which aims to introduce project-level reporting in several important directions. In particular, tax and other payments should be disclosed as well as information about project and social activity, essential contract terms, and beneficial owners. Such reporting, among others, is gaining momentum in

countries that are implementing the EITI (Extractive Industries Transparency Initiative) Standard and also in the EU member states that implement the requirements of specific directives. Over 90 reports have been published in the United Kingdom, while in Canada this number has almost reached 600.

Adoption of this law will allow to create an environment with zero tolerance to the corruption schemes with payments to the state, and also conditions for better governance of revenues from natural resources' extraction. Realization of this step will also increase the investors' trust and people's trust in the government which is extremely important for effective work of extractive sector, economy and energy security of Ukraine in general.

Adoption of the draft law «On Ensuring Transparency in Extractive Industries» will allow:

- *to ensure openness of public access to the information regarding extractive companies' payments;*
- *to increase the efficiency of sector's performance by means of increasing transparency of companies and state authorities which receive these payments;*
- *to detect improper fulfillment of the obligations, to prevent the emergence of corruption schemes (e.g., by means of providing rights to suspicious companies or those enterprises which do not explore the resources);*
- *comprehensive data disclosure (in particular, on final beneficiaries and details of all contracts granting the rights to use subsoil) will allow the government and the parliament to run adequate policy which reflects the real state of affairs and to make justified decisions.*

1. Keys gaps in natural recourse governance

The Resource Governance Index (RGI) – it is not just one of the rankings which allow to evaluate Ukraine’s place among other countries in terms of public policy efficiency. It is a useful tool which measures specific quality implications of policies in subsoil use, fiscal management, budget planning, financial reporting, state-owned companies’ governance, open data and others, which form the basis for good governance of natural resources.

According to Article 13 of the Constitution of Ukraine, land, its subsoil, atmospheric air, water and other resources belong to the citizens. Therefore, it is vital that the exploration of natural resources and the cost generated from this activity are used for the economic growth of Ukraine and for meeting citizens’ needs. Hence, RGI is a useful diagnostic tool which allows to objectively evaluate the quality of governance – moreover, both policy and its practical implementation. What are the results of such evaluation? What are the mistakes and drawbacks that were identified by the Index, and where Ukraine can demonstrate relative success?

The DiXi Group analyzed the latest edition of the Index and identified the components in which Ukraine scored less than the average number of points. These components relate to two general categories of the Index - *Value Realization* and *Revenue Management*.

Part I. Value Realization

Score 61 of 100

Extractive sector plays a very visible role in the national economy. Starting from 2011, the share of extractive industry in country's GDP has been steadily decreasing, and in 2016 it accounted less than 5%, including 2% in oil and natural gas production¹. Therefore, tax and rent payments have never been considered by the government as a considerable source for the creation of financial reserves and funds. This has influenced not only on the absence of separate financial institutions for accumulation of these revenues but also on the absence of separate budget accounts for such purposes. In other words, tax revenues from companies extracting hydrocarbons are not fundamentally different from other similar articles of budget revenues.

In this part of the RGI, Ukraine demonstrated mixed progress: on the one hand, the indicators of granting and controlling licenses (67 points) and administration of taxes (60) are not unsatisfactory, while on the other, there are significant gaps in terms of contract disclosure, tax reporting audits, as well as an unsatisfactory assessment in a set of indicators, grouped under the category "Local impact" (43). Let us examine these gaps in more detail.

Disclosure of contracts is the only major drawback in the **«Licensing»** component. The legislation of Ukraine does not yet require the publication of agreements on the subsoil use, production sharing agreements, joint activity agreements, or other contracts granting the rights to use subsoil. Their contents are currently considered as confidential. The Extractive Industries Transparency Initiative (EITI) standard, which is implemented by more than 50 countries (including Ukraine), encourages disclosure of contracts, and from 2018, this requirement will become mandatory.

1 State Statistics Service of Ukraine, statistical collections "National Accounts of Ukraine" for 2014, 2015, 2016. See <http://www.ukrstat.gov.ua/>

At present, 25 countries have already implemented this part of the EITI standard, with full or substantial disclosure on all contracts². Each of these states has its own legislative framework: for example, in Nigeria and the Philippines, it is written in the constitution, whereas in the Republic of Congo and Tanzania it is regulated by laws³. Advanced countries have followed the path of improving the legislation on corporate financial reporting. In particular, Norway, the United Kingdom and the U.S. have standardized the conditions for allowing oil and gas investments to enter their markets by incorporating the transparency requirements into relevant legislation.

The necessity for transparency is explained by the fact that some companies may attempt to reduce their tax obligations due to understatement of prices for minerals extracted and resale of the goods to subsidiaries or affiliated companies. The tax optimization occurs through lesser income, which is not accountable for taxation.

Despite the confidentiality clause, some improvements do take place in Ukraine. In 2015, information on owners of special permits for the subsoil use was disclosed, and the respective registry provides information about the specific conditions of each license. The relevant conditions are an integral part of the agreement for subsoil use, but contents of these contracts largely remain unpublished. In order to bring Ukraine's activities in line with best world practices, it is necessary to adopt appropriate legislation.

In **Taxation** subcomponent, the RGI indicates the fact that extractive companies are not subject to special audits different from usual audits. Moreover, according to the law "On Accounting and Financial Reporting" adopted in 1999, in some cases the application of International Financial Reporting Standards (IFRS) is not mandatory. Considering the fact that the largest extractive companies in Ukraine are state-owned (PJSC Ukrgezvydobuvannya – 100%, PJSC

2 http://repository.openoil.net/wiki/Main_Page

3 http://www.open-contracting.org/wp-content/uploads/2016/02/OCP2016_EITI_brief.pdf

Ukrnafta – 50%+1 share), it is very unlikely to observe voluntary application of IFRS instead of national system reporting system – in the cases when it is not required.

In turn, according to the EU best practices formulated in Directive 2013/34/EU, norms and requirements of accounting and financial reporting of extractive companies are significantly increased. In the framework of the Association Agreement between Ukraine and European Union, in 2015 the Cabinet of Ministers approved the implementation plan of Directive 2013/34/EU⁴ developed by the Ministry of Finance. The main measure of the plan was the development and adoption of amendments to the relevant national legislation.

In **Local Impact** component Ukraine got 43 out of 100 points which is one the worst indicators. This block covers a wide range of issues that should be accessible for local community, including the impact assessment of extractive projects on the environment, environmental mitigation plans, requirements for projects closure and also compensation payments to land owners or users.

A zero level performance was reported in the environmental impact assessment issue, despite the fact that Ukraine has a number of binding obligations in the framework of the EU-Ukraine Association Agreement and the Treaty establishing the Energy Community⁵. In particular, following the absence of results in implementing the requirements of Directive 2011/92/EU, the Energy Community Secretariat filed a special dispute settlement proceeding with Ukraine⁶. The relevant action plans aimed at implementation of the EU legislation⁷, as approved by the Cabinet of Ministers Resolution No. 475 of May 14, 2015, envisaged the

4 http://www.kmu.gov.ua/document/248090965/Dir%202013_34.pdf

5 In particular, Directive 2011/92/EU on the assessment of the effects of certain public and private projects on the environment, Directive 2001/42/EC on the assessment of the effects of certain plans and programmes on the environment, Directive 2003/4/EC on public access to environmental information, Directive 2003/35/EC providing for public participation in respect of the drawing up of certain plans and programmes relating to the environment. See further in policy study: http://dixigroup.org/storage/files/2017-05-10/report_2016_web.pdf

6 https://www.energy-community.org/portal/page/portal/ENC_HOME/DOCS/4332394/3D790302C9FD5024E053C92FA8COD492.pdf

7 http://www.kmu.gov.ua/kmu/control/uk/publish/article?art_id=248102785&cat_id=247984327

adoption of framework laws on environmental impact assessment (including transboundary ones) and on strategic environmental assessment by June and December 2015, respectively.

The draft laws “On Strategic Environmental Assessment” and “On Environmental Impact Assessment” remained under consideration by the parliament for longer than a year. In autumn 2016, the laws were adopted but immediately suspended by a presidential veto. After a long processing in the Verkhovna Rada specialized committee, only one of them – on environmental impact assessment – has been adopted at the end of May 2017⁸.

The citizens were enabled not just to request and obtain the necessary information on business activities anticipated to take place in their neighboring areas, but also to influence such plans through public discussions with their opinion to be taken into account. At the same time, the law itself will take effect as late as in December 2017, while its implementation requires additional work on the necessary by-laws that would ensure practical introduction of the proposed model.

Currently, the single biggest concern with regard to the draft law “On Strategic Environmental Assessment” in part of its compliance with Directive 2001/42/EU lies in its failure to cover urban planning documentation, including general plans of settlements. Carrying out SEAs of those countries employing this system, including the EU member states, to the contrary, indicates the overwhelming majority of the assessments relating specifically to the urban planning.

Overall, in addition to a weak legislative framework, Ukraine lacks established practices in assessing the environmental impact of oil and gas upstream projects. Even when the mentioned procedures are still being conducted, they usually bear rather fragmentary

nature, and the respective findings are rarely communicated to the local community publicly in an accessible and convenient way.

In part of compensation requirements, provisions of the Land Code in force require the companies which carry out exploration works to compensate land owners and land users for all losses, as well as to bring all the occupied land to its original condition (Articles 97, 156-157)⁹ at their own expense. In addition, the government has determined the procedure for calculating and compensating the losses to land owners and land users¹⁰. However, the practice of applying these norms (including the judiciary practice) varies significantly and tends to depend more on the arrangements between the community and the company rather than upon the provisions of the law.

The same situation persists in implementation of the law on alienation of property and involuntary resettlement from areas under industrial production of hydrocarbons. On the one hand, the Land Code (Articles 146-151)¹¹ and the dedicated law¹² lay down the basic rules and procedures for the transfer of ownership over a land plot and immovable property owned by an individual or a legal entity to the state or communal property for public or social necessity purposes.

On the other hand, in practice – especially when constructing roads and in other major infrastructure projects – some problems arise: the Ukrainian laws do not require public hearings or appropriate information to landowners and land users, nor do it provides for compensation or assistance with regard to the movable property¹³. In addition, there are no requirements to the contractors of such projects, including those in the extractive industries, for resettlement planning and specific way it should be conducted, including the plans for land alienation and involuntary resettlement.

9 <http://zakon2.rada.gov.ua/laws/show/2768-14/paran831#n831>

10 <http://zakon2.rada.gov.ua/laws/show/2768-14/paran831#n831>

11 <http://zakon2.rada.gov.ua/laws/show/2768-14/paran1458#n1458>

12 <http://zakon3.rada.gov.ua/laws/show/1559-17>

13 <http://documents.worldbank.org/curated/en/581691468114886401/pdf/SFG1205-RP-REVISED-P149322-PUBLIC-Disclosed-7-20-2015-Box393168B.pdf>

Combined, these factors effectually make the local communities unable to influence land and environmental issues in the areas of oil and gas production, or at least in obtaining respective information, and thus unable to conduct a dialogue with the companies on equal conditions. Often such disputes turn into conflicts and complicate exploration, and thus create discomfort for locals in extractive regions and generally do not contribute to the proper functioning of local authorities and self-government.

In the **State-Owned Enterprises** component, Ukraine scored fine in terms of state-owned assets management reform, transparency and financial reporting, while non-operational activities and assets were identified as a key gap.

In view of still high state presence in the extractive industry, especially in the oil and gas sector, as well as a low level of institutional capacity of the responsible authorities in general, the non-operational activity of Ukrainian extractive companies is considerable. According to the annual report of Naftogaz, the non-operational assets of PJSC Ukrkazvydobuvannya, nation's biggest gas producer, amounted to over 0.6 bn UAH and, in general, have been causing losses of 30 mln UAH per month, as audited in 2015¹⁴. On a larger scale, what underpins the problem is the poor quality of management that accompanied the company over the past decades rather than the risks of non-transparency of operations.

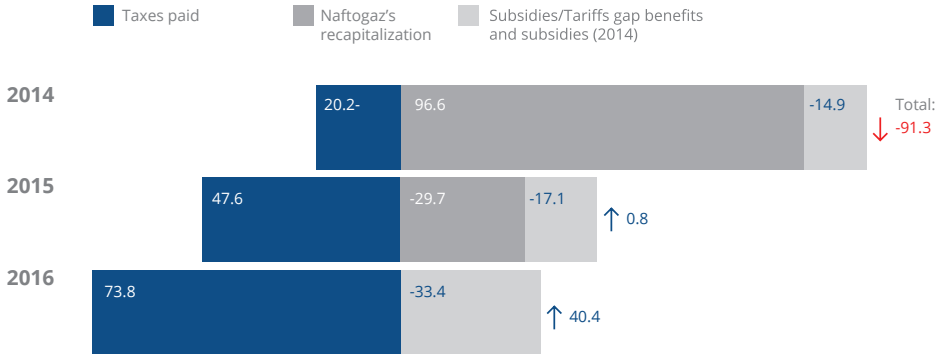
The biggest issue associated with the non-operational activity of extractive companies in Ukraine remains the significant social function imposed by the government upon gas producing companies through the mechanism of public service obligations (PSO). However, until recently the situation was next to a disaster: from 2010 to 2014 (the year reform stated), the government spent approximately 360 bn UAH on direct and indirect subsidies on natural gas consumed by households¹⁵. A significant portion of these funds was allocated directly through budget subsidies towards gas producing and supplying companies in state ownership, primarily NJSC Naftogaz of Ukraine and its subsidiary Ukrkazvydobu-

14 Річний звіт Групи «Нафтогаз»: <http://www.naftogaz.com/files/Zvity/Naftogaz-Annual-report-2015.pdf>, с. 91

15 https://www.iisd.org/gsi/sites/default/files/ffs_ukraine_draftinventory_ukr.pdf

vannya. The subsidies functioned to cover the gap between the price paid for gas resources (both imports and own production) and the regulated price paid by the final consumers.

FINANCIAL SETTLEMENTS OF NAFTOGAZ GROUP WITH THE STATE BUDGET IN 2014-2016 pp, uah bil



Source: 2016 NJSC Naftogaz of Ukraine Annual Report

In the circumstances of introducing market pricing principles, starting from May 1, 2016, the government has roughly equalized the natural gas prices across all categories of consumers. The hidden subsidies for nationwide consumption out of the state budget were replaced by a system of targeted subsidies for the most vulnerable citizens, with total volume increased from about 10 bn UAH in 2014 to 47 bn UAH foreseen by the State budget in 2017.

At the same time, the price at which Naftogaz supplies gas for municipal heating enterprises (for the needs of households' consumption) remains regulated. During the heating season 2016-2017, this price represented 50-60% of the wholesale market price. In order to complete the transition to competitive market, the government needs, on the one hand, to complete the fully-fledged natural gas market through removing numerous barriers for new retail suppliers to come. On the other hand, what is needed is to improve significantly the social care system by optimizing and verifying recipients and by introducing full monetization of all

households' benefits and subsidies. Given the extremely political sensitivity, as well as material economic implications of introducing market environment in the retail gas sector, implementation of this ambitious program should be expected rather later than sooner.

PART II. Revenue Management

Score 40 of 100

14 Unlike the value extraction of natural resources, according to the RGI, Ukraine does not have significant achievements concerning the management of revenues generated by the industry. Components such as "Subnational Resource Revenue Sharing" (due to lack of relevant legislation at the time of assessment) and "Sovereign Wealth Funds" (due to the lack of such practices) could not be accounted in the assessment. At the same time, the only component in this part dealing with budget planning and management of expenditures was estimated at low 40 points.

As already mentioned, Ukraine has shown weak indicators in the **National Budgeting** component. The analysis revealed sufficient transparency of the State Budget, its revenues and expenditures, as well as well-functioning systems of public debt management. At that, zero scores have been given for fiscal planning as back in 2016 Ukraine had no system of fiscal rules that would establish long-term fiscal constraints allowing to secure an acceptable level of public debt, as well as to limit the expenditures surges¹⁶. Specific importance of such rules appear with high volatility of prices for energy resources, which can fluctuate and significantly affect budget indicators.

The fiscal rules of Ukraine included the provisions of the Budget Code on marginal levels of public debt and state-guaranteed

debt (that should not exceed more than 60% of GDP), as well as of local debts (that should not exceed more than 200% of the expected development budget revenues, for Kyiv – 400%)¹⁷. Also, in each of the laws on the State Budget for the corresponding year, indicators of budget deficit, public debt and government guarantees for loans, as well as debt servicing payments, were set.

However, medium-term budget planning has been introduced in Ukraine only from 2017. The relevant amendments to the Budget Code¹⁸ were adopted by the Verkhovna Rada in late March and approved by the President in April. According to this document, the Ministry of Finance made an accurate forecast of the State Budget for 2018 and 2019, and presented the draft Guidelines for the Budgetary Policy for 2018-2020 (budget resolution), which was approved by the Cabinet of Ministers on June 14, 2017¹⁹. The next step is for the parliament, which will consider not only the budget resolution and the draft State Budget, but also a debt management strategy and a report on fiscal risks.

In general, the Ministry of Finance plans in the short term to reduce the budget deficit from 3% to 2%, and it also plans to reduce public debt to 55% of GDP. A three-year budget planning is the main element of the budget reform provided by the Coalition Agreement, the Strategy for Sustainable Development “Ukraine – 2020”, the government’s action program and the Public Finance Management Strategy for 2017-2020²⁰. At the same time, experts noted that the changes do not provide for mechanisms of regular review of macroeconomic indicators, which are the basis for the budgetary policy²¹. At the same time, it should be noted that the implementation of the fiscal rules system is a “pilot project”, since amendments to the Budget Code concern only for the period until 2020. In the future, as expected, in the framework of the budget reform, the government shall submit a completely new version of the Code.

17 <http://zakon5.rada.gov.ua/laws/show/2456-17/print1465416211799803>

18 <http://zakon2.rada.gov.ua/laws/show/1974-viii>

19 http://www.kmu.gov.ua/control/publish/article?art_id=250067274

20 <https://economics.unian.ua/finance/1838054-rada-priynyal-a-zakon-pro-formuvannya-byudjetu-na-tri-roki-vpered.html>

21 <https://www.epravda.com.ua/news/2017/03/23/622976/>

In addition, according to the RGI, Ukraine has not implemented any system for allocating on a single online data portal the information related to reserves, production and exports of natural resources. On the other hand, in Ukraine, under the auspices of the Ministry of Regional Development and the specialized State Agency for Electronic Governance, a single portal to disclose information in the open data format (data.gov.ua) was created. As of now, the portal is functioning in test mode, and its content, due to the extremely inadequate capacity of the responsible Agency, is not complete.

The procedure for the datasets to be published as open data, approved by the relevant regulation of the Cabinet of Ministers in October 2015, contains a list of information, which is administered by the Ministry of Energy, the Ministry of Environment and Natural Resources, and the State Service for Geology and Mineral Resources, and is subject to disclosure²². Unfortunately, these lists as well as the other information which is not related to natural resources, are incomplete and do not contain the most valuable information.

As of mid-2016, when the RGI was evaluated, there were no mechanisms in Ukraine for distributing the revenues from extractive industries to the benefit of local budgets. That is why there are no points for the component **Subnational Resource Revenue Sharing**, as most of the tax and non-tax payments paid by the extracting companies do not have a targeted distribution (except for social security contribution, which is directed to the Pension Fund and used to finance pension and social security spending)²³.

Of course, one can argue that Ukraine is moving away from a centralized tax management system. After the launch of the decentralization reform, the local budgets receive the following revenues from the extractive industry:

- *10% of corporate income tax,*
- *25% of rent for the use of subsoil for the extraction of other natural resources (except of oil and gas),*

22 <http://www.kmu.gov.ua/control/uk/cardnpd?docid=248573101>

- *100% of the land tax,*
- *up to 80% of the environmental tax,*
- *50% of the fee for water use,*
- *up to 60% of the personal income tax (distributed among different levels of regional budgets).*

Still the most targeted payment is the environmental tax, which is paid by extractive companies for the emissions of pollutants into the air or directly into water reservoirs. According to a special law, from January 1, 2016, it is accredited to special local budget funds and is directed exclusively into financing of environmental protection measures²⁴. The environmental tax is distributed in the following proportion: 20% to the State Budget, 25% to rural, township, city budgets, budgets of the united territorial communities, and 55% to the regional (oblast) budget. Also, special funds of local budgets receive 70% of revenues from monetary penalties for the damage caused by breaches of legislation on environmental protection, created by economic and other activities.

According to the State Statistics Service²⁵, in 2016 the State Budget received up to 1.62 bn UAH as environmental tax, while the rest 6.5 bn UAH were received by special local budget funds. According to the UAEITI report for 2014-2015, which covered sectors of oil, gas, coal, iron, titanium and manganese ore extraction, companies in this field paid more than 613 mln UAH in the form of environmental tax in 2014 and 462 mln UAH in 2015²⁶. However, it is usually difficult to trace the spending for environmental protection measures because the reports on the implementation of relevant programs or activities are almost inaccessible for the public²⁷, information may be received only under pressure from local councils and the civil society.

23 <http://eiti.org.ua/download/2235/>

24 <http://zakon2.rada.gov.ua/laws/show/918-19>

25 <http://www.treasury.gov.ua/main/uk/doccatalog/list?currDir=349925>

26 <http://eiti.org.ua/download/2235/>

27 <http://www.ppk.org.ua/uk/node/334>

Despite this, the main financial flows, in particular, rent payments (royalties) for oil and gas production, are only being paid to the State Budget and should also be transferred to local budgets for the provision of benefits and subsidies to households. In one way or another, about 77% of revenues from the extractive industry in 2014-2015 were distributed among the different regions of Ukraine²⁸. Another thing is that these payments are neither targeted, nor there is any direct connection between the paid and the received funds, regardless of it being an area, district or a community where hydrocarbon deposits are being developed.

As the RGI shows, many countries with high resource potential have systems or methodologies (formulas) for distributing the tax revenues to subnational level. Due to these mechanisms, the level of government intervention in local budgets is reduced, and local governments are able to make use of these additional resources.

In December 2016, Ukraine took the first step towards building such system, which is considered more just in terms of the interests of local communities. In accordance with the amendments to the Budget Code²⁹, starting from January 1, 2018, 5% of the royalties for the use of subsoil for the extraction of oil, natural gas and gas condensate will be distributed to local budgets. The state budget will receive 95% of these revenues, the rest will be distributed in the following way: 1% – to rural, township and city budgets, 2% - to the regional (oblast) budgets, and 2% - to the relevant district (raion) budgets. The exception is the budgets of cities with regional status, as well as the budgets of the united communities, which will receive 3% of this tax.

The decision on the royalties decentralization will significantly increase the financial resources in the local governments. According to the State Fiscal Service, in 2016 the State Budget received 36.6 bn UAH from rent payments (royalties) for oil, gas and gas condensate production, so local governments could receive an

28 <http://eiti.org.ua/download/2235/>

29 <http://zakon5.rada.gov.ua/laws/show/1793-19>

additional 1.834 bn UAH of income. According to DiXi Group estimates³⁰, taking into account the decrease in rent payments for oil production, which came into effect from January 1, 2017, the amount of expected revenues would decrease to 1.769 bn UAH.

Concerning the component **Sovereign Wealth Funds**, there are currently no funds within or beyond the budgeting system in Ukraine, which are sourced by payments from natural resources extraction. Typically, such funds in resource rich countries operate independently of the government and invest the revenues for getting profit. This, in turn, should support stability in the relevant markets, develop the economy, and accumulate financial resources for future generations.

At the same time, several years ago Ukrainian experts conducted an analysis of possible options of using the revenues: in particular, the revenues from the production of hydrocarbons (oil and gas) under production sharing agreements (PSAs) concluded by the government with leading investors (Shell, Chevron, Exxon-Mobil, Eni, EdF and others)³¹. Based on the study of the models of the Hydrocarbon Generations Fund in Poland, the experience of oil funds in Norway and Azerbaijan, analysts have proposed a concept and even a legislative initiative on the establishment of a National Wealth Fund as non-budget institution performing special functions.

The revenues were intended to be directed for use on projects supporting innovative potential of the economy, investment in education, research and development, support for health and social security systems. At the same time, such institution would allow to better manage the funds received from activities in the oil and gas sector. Also, it would have acted on fundamentally higher transparency standards (similar to ones on the stock market).

However, the conditions of the extractive business do not allow generating revenue flows sufficient to fill such a fund without significant loss of revenues to the State Budget. The mechanism for

30 <http://www.epravda.com.ua/columns/2017/05/19/625003/>

31 http://geostrategy.org.ua/images/Nomos_72p_www1.pdf

concluding the PSA has not been restarted yet, and the government supported the Concept for Development of Ukraine's Gas Production Industry by 2020³², which provides for the introduction of a stimulating fiscal regime to release investment for the development of new fields and intensification of production on existing fields. Also, despite lower rent payments for oil production, this business segment remains unprofitable³³.

Thus, the issue of creating a sovereign fund for managing oil and gas revenues is much lower on the political agenda, while the key issue is to increase production for achieving a higher level of energy independence.

2. Legislative initiatives for improving the resource management system

Licensing

For the time being, the draft law "On Ensuring Transparency in Extractive Industries" (No. 6229³⁴) is the only initiative able to bridge the gap in terms of disclosure of contracts. It introduces mandatory disclosure of information on the essential terms of agreements on the use of subsoil: in particular, their subject, date of entry into force and validity period, names of the parties, rights and obligations of the parties related to the use of subsoil, conditions on the peculiarities of payments, operating obligations, obligations on environmental protection measures, safety and health, and other social obligations.

The scope extends entirely to the agreements on conditions of subsoil use, production sharing agreements, joint activity agreements, and other agreements which allow direct project activity. In other words, these requirements do not extend on commercial contracts with contractors, service agreements and other commercial contracts.

32 <http://zakon2.rada.gov.ua/laws/show/918-19>

33 http://www.naftogaz.com/files/Zvity/Annual_report_ukr_170608.pdf

34 http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=61409

Taxation

At the moment, two draft laws are under consideration of the Verkhovna Rada, which are aimed at implementing the provisions of Directive 2013/34/EU – the draft law on amendments to the Law “On Accounting and Financial Reporting” (on improving some provisions) (No. 4646³⁵, amended No. 4646-d³⁶) developed by the government, and an alternative draft submitted by the inter-faction group of MPs (No. 4646-1³⁷).

The proposed draft laws substantially improve the national accounting legislation: in particular, the use of such new terms as “payments to government report” and “public-interest entities” is introduced. In addition, the significant value of this regulation is the responsibility of using not national but international standards of financial reporting for enterprises engaged in extraction of natural resources of national importance. Finally, the new legislation improves the procedure for filing and publishing financial statements for such companies in a single electronic format, and also obliges them to provide financial statements copies by the request of legal entities and individuals in accordance with the Law “On Access to Public Information”.

At the same time, the adoption of the draft law “On Ensuring Transparency in Extractive Industries” (No. 6229) will introduce mandatory disclosure of detailed information on the activity of extractive companies. The requirements of the EITI Standard and the EU directives introduced by this law include the results of the financial statements audit for the reporting period (for entities who have to conduct audit of financial statements according to the legislation).

The draft law adoption will improve the level of fiscal transparency and facilitate access to relevant information for the public, international investors and government agencies. Among the requirements established by this law is the annual disclosure by the companies of:

35 http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=59047

36 http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=62044

37 http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=59163

- *data on all types of payments to the government, including taxes, and revenues received by the state;*
- *data on the production share or other revenues the state received in kind;*
- *data on infrastructure charges and barter transactions;*
- *data on the revenues from pipeline transportation of hydrocarbons;*
- *transactions related to state-owned enterprises (such as state aid, financing from authorities and subjects controlled by them);*
- *data on the use of budget revenues from extraction, including subnational payments (in other words, payments in favor of local budgets).*

Adoption of the draft law “On Ensuring Transparency in Extractive Industries” will make submission of such reporting mandatory for all large companies engaged in the extraction of resources of national importance (i.e. all except for sand, rubble and some construction materials).

Local impact

After the adoption of the Law “On Environmental Impact Assessment”, the key challenge will be to ensure its implementation. It will require the development and adoption of secondary legislation. Another important step is the adoption of the draft law “On Strategic Environmental Assessment” (No. 6106³⁸), which needs to be substantially refined.

The proposed SEA model is generally compliant with Directive 2001/42/EU, however excludes such types of planning documents as urban planning documentation and local programs of economic and social development. “It is important that only sectoral plans and programs, which are subject to “approval”, will

38 http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=61186

require SEA”, note the experts in the monitoring report on the EU-Ukraine Association Agreement implementation³⁹. Experts also emphasize that the explanatory note to the draft law does not reveal the spending of state and local budgets that will be needed for conducting SEA of corresponding plans, programs and strategies.

More than 80 draft laws on amendments to the Land Code and related acts have been registered in the parliament of current convocation. However, MPs from the Committee on Fuel and Energy Complex, Nuclear Policy and Nuclear Safety, industry experts and business associations have discussed for a long time the draft law “On Amendments to Certain Legislative Acts of Ukraine Simplifying Certain Aspects of Oil and Gas Sector” (No. 3096-d⁴⁰).

It has received positive feedback from both Ukrainian experts and international partners, as this draft law aimed to deal with the overlapping of procedures for obtaining permits and assignment of land plots. According to the explanatory note, the process “lasts for an average 4 years and includes 44 permits from 16 institutions”.

Among other things, the document provides for amendments to the Land Code and the Law “On Oil and Gas” in part of ensuring the continuity of oil and gas fields development (land use under contract with the land owner or consent of the land user for a period of changing its intended purpose model and documentation), use of land plots without changing the intended purpose model (use of the easement mechanism for the construction of oil and gas facilities and pipelines), adequate protection of soil (compensation to land owners and land users of losses caused by the use of agricultural land for the needs of oil and gas industry and the loss of agricultural land).

39 http://enref.org/wp-content/uploads/2017/06/Monthly-February-2017_rs-1.pdf

40 http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=61900

State-owned enterprises

Further success in the issue of quality of the state assets management in the oil and gas sector largely depends on the corporate reform of NJSC Naftogaz of Ukraine. In particular, an important law-making initiative is the draft law on improvement of corporate governance of legal entities, with the state as shareholder (No. 6428⁴¹), approved by the Cabinet of Ministers. The document is intended to improve the management of economic activities of state-owned commercial enterprises. Among them, the following mechanisms are used for this purpose: establishing a state property strategy, regulating the distribution of powers between the board and the supervisory board, and reporting in accordance with international standards.

Transparency of state-owned extractive companies, including parent companies, can also be strengthened through the adoption of the draft law “On Ensuring Transparency in Extractive Industries” (No. 6229). It is intended to introduce mandatory disclosure for extractive companies of the information about tax they pay to budgets of different levels, in the context of their projects. Information will be made public in special annual reports of the companies, and reconciled with budget revenues in the framework of the Extractive Industries Transparency Initiative (EITI).

Moreover, the draft law also provides for project-by-project reporting, i.e. for each field or group of fields. It is anticipated that not only enterprises involved in the Ukrainian extractive industry should publish data on their payments to public authorities, but also the latter should disclose how much funds they received from the extractive industries. It will become an additional business safeguard, since it will allow to eliminate most of the law enforcement bodies’ claims on the payment of relevant tax and other obligations. The introduction of these rules, which reproduce the reporting regimes applicable in the EU, Canada, Norway, Australia, and other western countries, will be a powerful signal for foreign investors, as it will help to assess and even reduce the risks associated with the expected commercial participation in the extractive sector.

National budgeting

As for now, the further development and improvement of the Ukrainian open data portal (data.gov.ua), as well as the updating of the government resolution (additional datasets to be disclosed), are carried out by the civil society activists and with limited support from government agencies⁴². According to the latest information, the State Agency for E-Governance sent draft amendments to the central executive authorities for approval.

At the same time, the practice of implementation of the cutting edge technology of document circulation and e-governance in Ukraine provides significant grounds for expecting more success from the state portal of open data. In particular, it is a modernized public procurement system ProZorro, which, by virtue of the law "On Public Procurement" became mandatory in the public procurement and received worldwide recognition⁴³.

In addition, on March 10, 2017, the Roadmap for the Open Data Development in Ukraine was presented – a comprehensive action plan for 2017 for the implementation of the six principles of the International Open Data Charter, – which was developed following public consultations with representatives of business communities, civil society, and public authorities⁴⁴. Among the recent achievements of Ukraine is the more active implementation of blockchain technology into the system of state document circulation: after the signing of memoranda of Cooperation with the American company bitfury, the State Agency for E-Governance, the Ministry of Justice and the Ministry of Agriculture Policy and Food are already implementing joint pilot projects.

Thus, in the case of improving regulatory policy and strengthening responsible state bodies in terms of their powers and institutional capacity, a modern and powerful open data portal can be reasonably expected, as well as significant improvement of accountability and transparency in the field of natural resources management.

42 <https://www.slideshare.net/uaenergy/report-antikor-march2017revi>

43 <https://ti-ukraine.org/news/prozorro-dlia-bankov-kakov-rezultat-prodazh-aktyvov-bankov-bankrotov-povomou/>

44 <http://www.e.gov.ua/sites/default/files/roadmaptext.pdf>

Regarding the implementation of the fiscal rules fixed in the documents of medium-term budget planning, it will be important to improve the requirements for monitoring of economic macroindicators and appropriate adjustments to the budget resolution. This will be particularly relevant during the period of “pilot application” of the amendments to the Budget Code – until the new version of this document is developed and adopted. In the operational view, it is the responsibility of the government and the Ministry of Finance as key implementer of the Public Finance Management Strategy for 2017-2020.

Subnational resource revenue sharing

In view of the decision made on decentralization of rent payments (the Law No. 1793-VIII⁴⁵), it is very important to determine the mechanism for managing the funds received locally. After all, communities need not only to receive new revenues, but also to allocate the funds properly. It is important for the communities where active extraction activities for oil and gas are carried out, to monitor the state of local budgets and the decisions of delegated representatives of self-government bodies. In addition, for proper administration of these funds, public awareness and trust between companies, local governments and communities are needed.

The corresponding goal can be achieved by adopting the draft law “On Ensuring Transparency in Extractive Industries” (No. 6229). It is intended to introduce mandatory disclosure for extractive companies of the information about tax they pay to budgets of different levels, in the context of their projects. Information will be made public in special annual reports of the companies, and reconciled with budget revenues in the framework of the Extractive Industries Transparency Initiative (EITI). Moreover, the draft law also provides for project-by-project reporting, i.e. for each field or group of fields.

The local communities with exploration and production activities carried out on their territory are those who will benefit most. Their representatives will be able to check how much funds have actually been received at the level of local budgets, or whether the obligations are being fulfilled properly – both by the companies and the local authorities and local self-government which manage the funds. Finally, it is also profitable for businesses to reach a trust-based dialogue with communities.

In addition to the data on essential contractual terms and strictly financial information, the reporting requirements introduced by this draft law include data on the volumes of exploration and production of natural resources, on the beneficiaries (final owners) of extractive companies, and on the participation in social projects or programs. Submission of such reporting will be mandatory for all large companies engaged in the extraction of resources of national importance (i.e. all except for sand, rubble and some construction materials).

Sovereign wealth funds

In Ukraine, there are many initiatives to create both budgetary and extrabudgetary funds. E.g., in the Verkhovna Rada, draft laws were introduced and were not approved on the creation of the State Fund for Humanitarian Development of Ukraine⁴⁶, which should have been financed by share of the excise tax paid by producers and importers of alcoholic beverages and tobacco products, as well as the State Defense Capacity Support Fund⁴⁷, which should have been formed from the revenues of the State Budget which exceed the planned indicators.

At the same time, considering the priority of deregulation and the reduction of fiscal burden on the industry, aimed to increase gas production and achieving independence from energy imports, the creation of a sovereign welfare fund which would be financed

46 http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=57324

47 http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=54135

by resource payments does not seem appropriate. At the same time, this should not restrain stakeholders – public authorities, business community, experts and international partners – from discussing such fund as one of the forms of independent and transparent management of revenues from extractive industries. Moreover, in case if the policy of incentivizing the extraction of natural resources, especially natural gas, will be successful, the volume of the market and the corresponding revenue flows will be only increasing.

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