



Preparing for a Successful Peace

Consolidating Corporate Governance in
Ukraine's Energy State-Owned Enterprises

By Aura Sabadus

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Cover photo: Pressure gauges, pipes and valves are pictured at an «Dashava» underground gas storage facility near Striy, Ukraine May 28, 2015. Ukrainian state energy firm Naftogaz paid Russia's Gazprom another \$30 million in prepayment for gas supplies, the Ukrainian company said on Wednesday.

Credit: REUTERS/Gleb Garanich

Contents

Summary.....	3
Background.....	6
Who Pulls the Strings	10
The Challenges of Rebuilding.....	12
SOE Case Studies	12
Recommendations	22
Endnotes.....	26

Acknowledgements

This report benefitted from expert insights of current or former members of the Energy Community, EU, OECD, Ukrainian energy SOEs, Ukrainian members of parliament, corporate governance analysts, digital entrepreneurs, and Ukrainian and EU-based electricity and natural gas traders.

The author wishes to extend her special thanks to Anders Åslund, Huberte Bettonville, Olga Bielkova, Walter Boltz, Andriy Boytsun, Dirk Buschle, Oleksandr Lysenko, Sergiy Makogon, Viktor Nestulia, Aliona Osmolovska, Clare Spottiswoode, Torsten Woellert, Andrii Zhupanyn, and others who did not wish to be named but who contributed equally valuable comments.

Deputy Energy Minister Farid Safarov as well as deputy head of the office of the president of Ukraine and Naftogaz supervisory board member Rostyslav Shurma were also invited to take part in interviews but did not respond.

Author biography

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Summary

Embedding proper corporate governance practices into Ukraine's state-owned enterprises (SOEs) has been key to cementing reforms made since the Revolution of Dignity in 2014, such as the deregulation of energy markets or the liberalization of the banking sector. As Ukraine prepares for postwar reconstruction, which will inevitably require international financial support, the need to improve transparency and consolidate the independence of SOEs to minimize the risk of corruption takes on new urgency.

This paper draws on the work of CEPA's Democratic Resilience Program and European Energy Security Working Group, through extensive interviews and documentary research, as part of the institution's broader focus on Ukrainian resilience and recovery. It stresses the need to ensure the independence of energy SOEs and the accountability of supervisory and executive boards as a guarantee for the integrity of future investments and reform.

The analysis starts off with an outline of the evolution of corporate governance reform in Ukraine following the dissolution of the Soviet Union in 1991, including a description of the international standards that helped shape initial practices and the challenges in adopting them across state-owned enterprises.

The discussion focuses on energy SOEs as some of the most profitable state companies and is backed up by four case studies illustrating the achievements and the difficulties in implementing corporate governance standards before and after the start of Russia's all-out invasion in February 2022.

The first case study shows how the oil and gas incumbent, Naftogaz, which had been selected as a flagship for corporate governance reform, was repeatedly subject to political interference, often aligned with vested oligarchic interests, particularly under the predecessors of the current president, Volodymyr Zelenskyy. The introduction of martial law has led to a concentration of power, granting Naftogaz a monopoly in the natural gas sector, which although justified by security constraints, raises questions about Ukraine's commitment to establishing a competitive energy industry.

The second case study turns to the idiosyncratic corporate governance structure of the gas transmission system operator, GTSOU, and the difficulties that its complex ownership has created, potentially jeopardizing its certification as an independent company and even its ability to continue transiting Russian gas to Europe. Political attempts to interfere with its activity have led to a series of dismissals and resignations of board members and executives. Nevertheless, new legislation reflecting benchmarks set by international financial institutions is expected to correct some of its structural flaws and grant greater protection from political intrusion.

Distribution of Electricity Generation in Ukraine (2022)

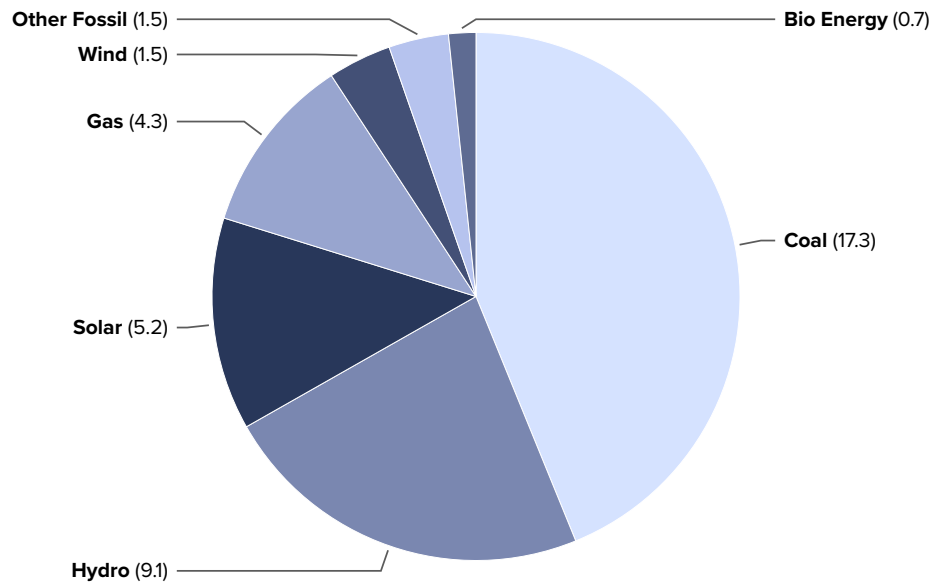


Chart: Center for European Policy Analysis.

Source: Published by Statistica Research Department, July 19, 2023.

The third case study highlights electrical grid operator Ukrenergo, which is central to Ukraine's reconstruction efforts and the country's goals to integrate with the wider European electricity infrastructure. Despite its importance, and even as Russian missiles targeted the transmission system in recent months, the company's ability to act decisively has been affected by a year-plus vacancy on its supervisory board that left it without a qualified majority. Because of the vacancy, independent members could not form a majority of the board, failing to meet the requirements of the law or Ukrenergo's charter.¹ Furthermore, the panel had not had a chairperson until the end of August 2023 when one of the existing independent board members, Daniel Dobbeni was elected, helping to sway the balance of votes in favour of the independents as the vote of the chairperson counts twice.

Finally, the fourth case study describes the steps taken to incorporate the nuclear power producer, Energoatom, which will be at the heart of efforts to rebuild the energy system once the war ends. As part of the corporatization process, intended as a safeguard against corruption, the government aims to appoint a supervisory board before the end of the year. Still, the war and related difficulties, including Russia's occupation of the Zaporizhzhia power plant, have slowed down the process so that Energoatom has missed key deadlines set by international financial institutions.



Vehicles are on fire at an oil depot after missiles struck the facility in an area controlled by Russian-backed separatist forces in Makiivka, east of Donetsk, eastern Ukraine, May 4, 2022. Credit: Manhai, Flickr May 9, 2022.

Based on these case studies, this paper offers the following findings:

- Tightening up corporate governance rules in energy SOEs, which are likely to attract large funds, should be a priority for the Ukrainian government and international donors.
- Some important steps have been taken, but corporate governance safeguards in Ukraine's largest energy SOEs² remain weak. The sector is witnessing a concentration of political power — arguably justified by the current extraordinary security concerns and the imposition of martial law — even as the influence of some oligarchic interests may be receding.
- However, recent developments at Ukraine's top energy SOEs and interviews with Ukrainian and Western stakeholders³ suggest that rather than guaranteeing the security of the sector, the increased political interference may put it at risk, potentially leaving it ill-equipped to receive international assistance.
- Civil society, domestic and international energy companies, and international financial institutions continue to push for more transparency and accountability, and for tighter corporate governance rules and practices.

Background

The adoption of corporate governance rules in Ukrainian SOEs was meant to promote their efficient management, minimize corruption, depoliticize the decision-making process, and allow the citizens of Ukraine — the ultimate owners of the SOEs — clear insight into their performance.⁴

The earliest steps were taken in 2003, when the National Securities and Stock Market Commission, which polices capital markets, released Ukraine's first corporate governance principles,⁵ which were subsequently revised in 2008 and 2014 and are based on the Organisation for Economic Cooperation and Development (OECD) principles of corporate governance for publicly traded joint stock companies.⁶

Corporate governance refers to a system of rules and practices that determine how a company is controlled and how its objectives, and the means of attaining them, are set. It involves a set of relationships among a company's supervisory and executive boards, shareholders, and stakeholders, and guides every sphere of management, including financial reports, contracting, listing rules, and voluntary commitments.

Basic principles of corporate governance include accountability, fairness, responsibility, risk management, and transparency, which are nonbinding, but adopting and implementing well-designed corporate governance policies based on these principles can help companies tap international capital markets, build trust with investors, and provide guidance for long-term success. Corporate governance standards can apply in the private sector as well as to SOEs, whose distinct challenges can include political interference, leading to unclear lines of responsibility, a lack of accountability, and inefficiency, or a lack of oversight due to passive state ownership.

The OECD recommends the following best practices for governments that own SOEs⁷

- Develop an ownership policy for SOEs to maximize value for society, which should be subject to appropriate political accountability and disclosed to the public.
- Ensure that the governance of SOEs is transparent, accountable, professional, and effective.
- Guarantee a level playing field and fair competition in the marketplace when SOEs undertake economic activities.
- Where SOEs are publicly listed or otherwise include nonstate owners, the state and the enterprises should recognize the rights of all shareholders and ensure shareholders' equitable treatment and equal access to corporate information.

Preparing for a Successful Peace

- Request that SOEs report on their relations with stakeholders and be clear about expectations for responsible business conduct by SOEs.
- Ensure SOEs observe high standards of transparency and abide by the same accounting, disclosure, compliance, and auditing standards as listed companies.

Failure to follow these rules can lead to poorly structured boards, increased political interference, clashes with auditors, and noncompliant financial reporting, among other issues.

While some principles are fundamental, corporate governance models can differ across various economies. For example, the Anglo-American model privileges the interests of shareholders and typically relies on a single-tiered board that is normally dominated by nonexecutive directors. Under this arrangement, it would be the shareholders who would appoint the CEO of a socially owned enterprise. The Continental model, seen in countries such as Austria, Germany, and the Netherlands, weighs the interests of multiple stakeholders, including managers, workers, suppliers, and customers. Some countries that champion this model require a two-tiered board of directors made up of executive and supervisory boards.

Ukraine has a two-tiered system, which would typically mean the supervisory board would hire or fire the CEO, although the government has used legal loopholes to maneuver around that and there is a precedent in 2021 when the government suspended the company's board for 48 hours and directly fired the CEO. SOEs or any company that wants to be listed in Ukraine are supposed to comply with the rules and practices formulated by the OECD⁸ to ensure accountability and transparency, but that does not always happen, for reasons that are by no means particular to Ukraine.⁹¹⁰

- Ukraine was traditionally a hierarchical society, with decisions made subjectively by leaders (the Communist Party, oligarchs, politicians) rather than based on objective criteria.
- There is a general lack of understanding of corporate governance, which is seen as an imported concept.
- Vested political and oligarchic interests have seen the introduction of independent supervisory boards with the power to appoint CEOs or approve SOEs' budgets as a threat.

Over the years, these factors have given root to crony capitalism, characterized by a high concentration of capital in the hands of a few business owners who have benefited from strong political connections, fragile institutions, and a weak rule of law.¹¹ The alignment of big business and political interests has endured for years,

Preparing for a Successful Peace

encouraging rent seeking over general wealth creation¹² and lucrative energy SOEs have been particularly vulnerable to predatory oligarchs. Oligarchs long used an opaque procurement system or market-distorting subsidies to line their pockets, but the Revolution of Dignity of 2014 and the ensuing reforms, which set Ukraine on a Westerly course, put a stop to some of that, including in the energy sector, hitherto seen as one of the biggest sources of corruption.¹³

Key Events

Month/Year	Description
1992	Ukraine Adopts law on privatization of state owned assets
1996	Ukraine establishes Energoatom
1998	Naftogaz becomes a joint stock company
2003	National Securities and Stock Market Commission (NSSMC) releases first Ukraine corporate governance principles
2008	NSSMC amends corporate governance principles
February 2011	Ukraine becomes contracting party of Energy Community
February 2014	The Verkhovna Rada votes to remove incumbent president Viktor Yanukovich from power
March, 2014	Naftogaz appoints Andriy Kobolyev as CEO
July 2014	EBRD and EIB condition €300m loan to Naftogaz for pipeline upgrade on adoption of corporate governance reform
December 2014	Naftogaz initiates discussion on corporate governance principles in state owned enterprises
July 2015	Corporate governance action plan presented to cabinet of ministers
March 2016	First supervisory board of Naftogaz appointed
September 2017	First supervisory board of Naftogaz resigns
December 2017	Second supervisory board made up of seven members appointed
February 2018	Naftogaz wins \$4.6bn arbitration award against Gazprom
July 2018	MGU established as holding company at GTSOU. First supervisory board appointed at MGU
July 2018	First supervisory board appointed at Ukrenergo
July 2018	NABU initiates investigation into Andriy Kobolyev arbitration bonus, claiming embezzlement.
December 2019	Gas transit contract renewed with Russia's Gazprom for five years.
January 2020	Newly unbundling gas transmission company, GTSOU starts operation

Additional 28 rows not shown.

Table: Center for European Policy Analysis.

Preparing for a Successful Peace

As a contracting party of the Energy Community — an international institution working to extend the EU's internal energy market to neighboring nonmember countries — Ukraine committed to aligning its electricity and gas market rules with those of the EU a decade ago. To some early success, officials introduced corporate governance reforms in energy SOEs to cement key structural changes, although the process faltered in its implementation.

Interviewees reported that corporate governance reform was pushed through by a handful of specialists who had been educated abroad or worked for international law firms, as well as by international financial institutions. Domestic policymakers, they said, had a vague understanding of the concept, which ironically, might have been one reason the government of Arseniy Yatsenyuk willingly rolled out OECD corporate governance standards at the end of 2014. Andriy Boytsun, a specialist who helped promote and draft corporate governance guidelines, said the concept sounded “abstract, more like a declaration of human rights,” which meant politicians did not perceive it as a threat, but thought that embracing it would smooth negotiations with international financial institutions.

In 2015, the European Bank for Reconstruction and Development and the European Investment Bank agreed to collectively loan €300m (\$336m at the time) to the gas incumbent, Naftogaz, for repairs to the major Urengoy-Pomary-Uzhhorod pipeline in exchange for reforms to the gas market and in corporate governance at Naftogaz and the then-gas transmission operator, Ukrtransgaz.¹⁴

Boytsun said several proposals, including the introduction of supervisory boards with a majority of independent members, were adopted without opposition, as they were not perceived as a risk to political or oligarchic interests.¹⁵ Other proposals, however, such as empowering supervisory boards to appoint CEOs and approve SOEs' budgets, encountered too much opposition to be included in legislation.

Subsequent events, including multiple changes in governments, Zelenskyy's election in 2019, and Russia's all-out invasion in February 2022, had a stop-and-go effect on the implementation of corporate governance standards in energy SOEs. Boytsun noted that former president Petro Poroshenko greenlighted the primary legislation on corporate governance in 2016 only after Ukrainian defense state-owned enterprise Ukrboronprom was excluded over national security concerns.¹⁶

Then under the government of Prime Minister Volodymyr Groysman, from 2016 to 2019, political pressure appeared to slow the process. For example, when Naftogaz struggled to get upstream production licenses, then-CEO Andriy Kobolyev complained that Groysman's government favored private producers over Naftogaz, and hinted at corruption.¹⁷

With the election of Zelenskyy in 2019 and, in particular, following the appointment of Prime Minister Denys Shmyhal's government in 2020, political pressure on Naftogaz abated. Interviewees said the incumbent could once again get production licenses and noted that the government even temporarily supported the deregulation of gas prices for households and heating companies, paving the way for a free market, independent of political intervention.

Circumstances changed again with Russia's full-scale invasion in February 2022, when the energy sector saw a concentration of power following the introduction of martial law, with one interviewee close to the government noting that politicians saw energy SOEs as "resources to hand," akin to troops or equipment, that could be mobilized as part of the war effort. Despite wartime conditions, there are encouraging signs of reform in the corporate governance structure of the gas transmission system operator, GTSOU, after legislation was adopted at the end of July 2023 to meet conditions imposed by the International Monetary Fund (IMF). Also, this year, the government is expected to complete the corporatization of state-owned nuclear producer Energoatom.

All in all, Ukrainian and international observers see a mixed bag, noting that even though supervisory boards were introduced at Naftogaz, Ukrenergo, and GTSOU, they were never fully independent or enabled to make decisions on issues such as the appointment of CEOs or companies' budgets.

Who Pulls the Strings

The major difference in SOE governance before and after the start of war in February 2022 is that prewar political interference, in particular under Groysman's government during Poroshenko's presidency, tended to align with entrenched oligarchic interests,¹⁸ whereas now the influence of some once-dominant oligarchs, such as Ihor Kolomoisky and Dmytro Firtash, has waned while political influence has waxed.

Notably, the government recently seized Kolomoisky's 42% stake in the country's largest oil company, Ukrnafta,¹⁹ and seized or froze assets held by Firtash, a Kremlin-backed fugitive from Ukraine, amid allegations of embezzlement.²⁰

In another example, a Ukrainian journalist²¹ has chronicled the increasing influence of a network of top officials, including in the president's office, the Energy Ministry, and the NEURC energy regulator, over the energy industry.²² Although many in this network worked at an international steel and mining group controlled by Ukraine's richest man, Rinat Akhmetov, it is unclear if his interests are behind this coalescence. Rather, it is likely a shift in control of strategic industries from an entrenched oligarchic class to a small political elite in response to wartime exigencies. Russia's systematic destruction of some oligarchs' industrial assets has helped to weaken



Photo: Naftogaz Group's Ukgazvydobuvannya has drilled and put into operation another high-rate well in eastern Ukraine that provides the country with an additional 230 thousand cubic meters of natural gas per day", June 5, 2023. Credit: Naftogaz Group, <https://www.naftogaz.com/en/news/naftogaz-group-launches-another-prolific-new-well>.

their influence over SOEs, while the introduction of martial law at the start of the invasion has given extensive powers to top functionaries.

With international institutions prioritizing the war efforts and paying comparatively less attention to corporate governance, the stability of energy SOEs could be undermined by political interference with their nominally independent supervisory boards and observers say Zelenskyy may not be aware of the importance of corporate governance rules for SOEs. Interviewees acknowledged that under the current harrowing circumstances, increased political influence over strategic sectors such as natural gas and electricity are mostly understandable, but they worried that without greater transparency and the adoption of corporate governance rules, and penalties for violations, postwar reconstruction of the industry will falter. They noted that breaches of corporate governance rules currently carry no criminal or civil liabilities and that boards' performance is not subject to public scrutiny despite their members' high salaries. They also said anti-corruption authorities may have been targeting reformers²³ rather than those who misappropriated funds.

The Challenges of Rebuilding

Regardless of how quickly the war ends, Ukraine's energy sector faces multiple challenges, including attracting hundreds of billions of dollars to rebuild its electricity infrastructure, half of which has been destroyed by Russian missile attacks.²⁴

The country's gas industry also needs to rethink its role, as nearly six decades as the main transit route of Russian gas to Europe comes to an end with the expiration of the current contract with Gazprom at the end of 2024.

Ukraine will need to break its historic addiction to coal-fired power plants in keeping with its commitment to become a net-zero-carbon economy by mid-century. All these challenges require comprehensive reform, whose success will depend on the transparency and ability of SOEs to see it through.

SOE Case Studies

Ukraine's first post-Soviet attempt at privatization in 1992 was a fiasco as opaque sales to well-connected buyers at depressed prices soured the public on the program, and the government retained control of 3,293 SOEs, less than a third of which have turned a profit in recent years.²⁵

Although most SOEs are in agriculture and manufacturing, the most profitable are in the energy industry. According to a 2021 OECD report, 18 SOEs in oil, gas, and electricity have remained some of the most profitable, with oil and gas incumbent Naftogaz driving much of the revenue.²⁶ Given its importance to the economy, Naftogaz was chosen as a flagship for corporate governance reform, followed by other energy SOEs, such as the gas and electrical grid operators, which are critical to the stability of the energy sector.

Despite achievements such as the establishment of independent supervisory boards, SOEs remain vulnerable to political interference, with board members either resigning amid complaints of political obstruction or being dismissed, often in disregard of corporate governance practices adopted by those SOEs. Making structural changes in a society where rent-seeking has been endemic and where there has been a historic mistrust of state institutions will be very difficult but not impossible.

On a positive note, interviewees said the country was already on a path to irreversible change, as the powers of established oligarchs have been shrinking as their industrial base has been destroyed during the war. Meanwhile, civil society is becoming increasingly aware of the need to shore up the credibility of state



Photo: Energy infrastructure destroyed by Russian drone strike, October 27th, 2022. Credit: State Emergency Service of Ukraine.

institutions, and, despite the difficulties of the war, Ukraine has moved up the ranks of Transparency International's most recent Corruption Perceptions Index.²⁷

Since the Revolution of Dignity in 2014, Ukraine has made important steps to establish a transparent procurement system, an asset-declaration system, and a public database of top politicians and officials, or politically exposed individuals, to help banks or potential business partners conduct due diligence.²⁸ Advances in digital technology may speed the process, as an emerging class of Ukrainian entrepreneurs develops tools to monitor all funds that are likely to pour in, enhance transparency, and improve accountability across the board. Ukraine's international partners also understand that the country's reconstruction and successful bid for EU membership hinge on curbing corruption and restoring trust in government institutions, including SOEs.

In fact, dozens of international energy companies surveyed by the author say they are keen to do business with their Ukrainian counterparts, make use of the country's vast natural-gas storage facilities, or invest in renewables there. They acknowledge

Preparing for a Successful Peace

the physical risk to infrastructure posed by Russian missile attacks but say an equally significant risk lies in Ukraine's political meddling in the energy sector.²⁹

The government and international donors are working to develop war-risk insurance to protect assets, but international financial institutions say Ukraine must also stabilize and elevate corporate governance. The Energy Community, which since the Revolution of Dignity has been helping Ukraine reform its electricity and natural gas markets, has recently begun monitoring all legislative changes affecting the industry and corporate governance in energy SOEs.³⁰ At the legislative level, Ukraine has established anti-corruption bodies, although recent cases that targeted high-profile reformers, including a former CEO of Naftogaz, have raised questions about their motivations and effectiveness.

Ukrainian State Owned Enterprises Net Profits (USD, 2021)

Ukrainian SOE	Date created	Focus Area	Consumers
Ukrenerg	1993	Nuclear	12.4 million household consumers (97.6% of the market)
Energoatom	2005	Nuclear	Household consumers
GTSOU	2020	Natural Gas	Natural gas consumers in Ukraine and the EU
Naftogaz	1996	Oil and Gas	50% household consumers, 50% large buyers

Table: Center for European Policy Analysis.
Source: Ukrainian News.

The case studies below track the evolution of corporate governance reform in four key energy SOEs, highlighting the achievements to date but also the problems that have become evident since the start of war and the imposition of martial law.

Naftogaz

Naftogaz is a successor to the State Committee of Oil and Gas, which was established in 1993 under the Cabinet to control all state-owned oil and gas companies. After the failed privatization process of the 1990s, Naftogaz was established in 1998 as

a joint stock company. In addition to Naftogaz itself, the umbrella Naftogaz Group includes seven other joint stock companies, nine subsidiaries, seven representative offices and fully owned affiliates, as well as shares in other companies.³¹ In other words, its business extends from upstream oil and gas production to gas storage operations, oil transportation, and wholesale and retail trading.

Long a major source of corruption and particularly vulnerable to Russian influence, Naftogaz has been at the forefront of the government's corporate governance reform. Although it has made progress since its first corporate governance charter was adopted in 2014, including winning a multibillion-dollar arbitration ruling against Gazprom in 2018, the company remains vulnerable to political influence.

Naftogaz's first independent supervisory board was appointed in spring 2016, with three international independent members and two government representatives, only to wind down in September 2017 as members resigned in protest over political interference from Groysman's new government.³² A new board was appointed, made up of four independent members and three government representatives, but the political interference continued, targeting not only board members but also Kobolyev, the CEO, who quipped that it had become difficult to keep count of the prosecutions instigated against him and the company.³³

The attacks continued after the election of Zelenskyy in 2019 and culminated in April 2021, when the government dismissed the supervisory board and the CEO only to immediately reappoint the board.³⁴ The move flouted an amendment to Naftogaz's corporate charter giving the board hiring and firing authority over the CEO that had been a structural benchmark set in 2020 by the IMF as part of a \$5.5bn stand-by aid agreement and Clare Spottiswoode, a respected expert on the European gas industry who chaired the supervisory board, said the maneuver "made a mockery of corporate governance rules."³⁵ Yuriy Vitrenko, the CEO appointed by the government shortly afterward, defended the government's decision, citing performance concerns linked to the outgoing CEO and the dismissed supervisory board. But the appointment of Vitrenko, who was acting energy minister before taking the helm of Naftogaz, was seen as going against a requirement that civil servants who leave their government posts wait one year before accepting an SOE position. In any event, Vitrenko's tenure was short-lived and he resigned in November 2022 as a government edict that Naftogaz sell gas to consumers at lower rates than its competitors drove it to the edge of default.³⁶

The government appointed his replacement the same month, four months ahead of the selection of a new supervisory board, which interviewees noted was yet another violation of the company's amended charter. If before the war political influence over SOEs aligned with vested oligarchic interests, the introduction of martial law in the wake of Russia's all-out invasion in February 2022 may have also emboldened



Photo: A serviceman with a Russian flag on his uniform stands guard near the Zaporizhzhia Nuclear Power Plant in the course of Ukraine-Russia conflict outside the Russian-controlled city of Enerhodar in the Zaporizhzhia region, Ukraine August 4, 2022.
Credit: REUTERS/Alexander Ermochenko.

the ruling elite to use Naftogaz to tighten its grip on the gas market. For example, Naftogaz has been historically obliged to sell gas to household consumers at prices well below the market. A few years ago, Naftogaz management began looking into whether regional gas suppliers owned by Firtash had bought some of that discount gas, ostensibly to sell it to household consumers, but instead sold it to commercial customers, who pay higher rates, and pocketed the difference.³⁷ Last year the government seized or froze some of the assets of Firtash's Regional Gas Company and placed them under the control of Naftogaz as part of a criminal investigation, effectively cementing the role of the incumbent in the market.³⁸

The introduction of martial law has given Naftogaz a monopoly in the market, while the government has banned the export of Ukrainian gas to premium European hubs, putting private producers in a bind. Energy companies in Ukraine want the market to be reopened and the reforms spurred by the Revolution of Dignity in 2014 to continue, but some interviewees said reformers may be unwilling to step forward amid fears that they will become targets of anti-corruption bodies seeking to prove themselves.

Kobolyev, the Naftogaz CEO dismissed during the board's suspension in April 2021, offers a cautionary example. Under his management, the company went from soaking up 27% of the state budget in 2014 to contributing a net €3.6bn (\$4bn) to government coffers in 2019.³⁹ Still, he is accused of misleading Naftogaz board members into paying him a large bonus in 2018 after winning an arbitration against Gazprom that earned Naftogaz \$4.6bn. If convicted, he faces up to 12 years in prison. He denies wrongdoing.

Anti-corruption activists say the award exceeded a cap on bonuses at SOEs, of which supervisory board members might not have been aware but interviewees said the episode shows the need for greater clarity on SOE rules and regulations and, along with cases against other senior technocrats credited with improvements at SOEs,⁴⁰ raises questions about the government's sincerity about reform.

GTSOU

The gas transmission system operator of Ukraine, GTSOU, was established as an independent limited liability company in 2020 following the unbundling of transmission operations from Naftogaz. Its shareholding structure differs from that of other SOEs because the company is owned by MGU, a shell company, which is in turn owned by the Energy Ministry, and the supervisory board sits at MGU rather than directly at GTSOU.

Allegations of political interference at MGU arose almost immediately after the transmission operations were unbundled. The Finance Ministry, at the time the sole owner of MGU, abruptly fired the chair of the shell company's supervisory board, prompting resignation threats from two of the remaining three independent board members and concern from international stakeholders, including the European Commission and the Energy Community, which had certified GTSOU as an independent operator.⁴¹ The operator's political independence was a condition of a lucrative, five-year contract it had secured with Gazprom for the transit of Russian gas to European buyers via Ukraine.

When a new energy minister, Herman Halushchenko, was appointed, a decision was taken to move GTSOU and the electrical grid operator, Ukrenergo, from the jurisdiction of the Finance Ministry, which had been regarded as a neutral overseer, to the control of the Energy Ministry, raising concern about the companies' independence and continued certification. Later, when a new supervisory board was selected for MGU in 2021, domestic corporate governance analysts protested that the government had directly appointed a former politician, without the required review by a committee made up of foreign and domestic stakeholders.⁴² There were also concerns that the new board member had been a minister of finance

in the Cabinet of former prime minister Yuliya Tymoshenko, who had opposed the unbundling of gas transmission operations.⁴³

Halushchenko's appointment became a source of friction with the independent members, including the chair, who resigned at the beginning of 2023. Huberte Bettonville said the board had come under repeated political interference during her 15-month tenure, failing to achieve tangible results⁴⁴ She blasted unnamed board members who had "proved that they will not and cannot apply EU standards and corporate governance principles."⁴⁵ In September 2022, during Bettonville's tenure, the board fired the CEO of MGU about a month after a high-ranking official in the Energy Ministry had demanded that the board appoint another ministry official to lead the company.⁴⁶ The firing and the ministry official's demand raised the specter of political interference, which, by undermining the transit operator's independence, ultimately could have threatened the Gazprom contract, which brings in 80% of GTSOU's annual revenue.⁴⁷

Appointing a ministry official also would have violated the rule on conflicts of interest that requires at least one year between holding a government post and working at an SOE, which prompted the government to back off in the face of domestic and international pressure. Instead, a former colleague of one of the president's advisers⁴⁸ was appointed CEO.⁴⁹ Interviewees also criticized the Energy Ministry and National Securities and Stock Market Commission, as shareholder and supervisory body respectively, for failing to carry out performance reviews at MGU or to hold the supervisory board accountable. The MGU supervisory board only published reports on its activity or compensation in 2018 but failed to do so after that⁵⁰ despite calls for greater scrutiny of members, who by one assessment are paid better than those of their counterparts elsewhere in Europe.⁵¹

Ukraine's international partners have called for an overhaul in the shareholding structure of GTSOU, and the IMF has made it a condition for disbursing a new tranche of funds.⁵² To that end, parliament passed a bill in late July 2023 to disband MGU and put GTSOU under the direct ownership of the Energy Ministry. The government intends to have the reforms in place, including a new charter, supervisory board, and CEO for GTSOU, by the end of October

Ukrenergo

Ukrenergo was established in 1998 from the merger of two SOEs, the National Dispatching Center and the Ukrelektroperedacha electricity company⁵³ and currently acts as a natural monopoly, operating the electrical grid, balancing production and consumption, administering commercial metering, and coordinating cross-border electricity flow with neighboring EU countries.



Photo: Firefighters work to extinguish fire following recent shelling at an oil storage in the course of Russia-Ukraine conflict in the town of Shakhtarsk, October 27, 2022. Credit: REUTERS/Alexander Ermochenko.

In 2019, Ukrenergo was the fifth largest SOE by asset value and revenues in Ukraine and had approximately 8,000 employees.⁵⁴ Its profitability has fluctuated over the years, thanks more to tariff policies than market conditions. In 2019, for example, its revenues grew substantially, but a year later it owed significant debts to Guaranteed Buyer, a state company that pays independent producers of renewable energy that is fed back into the grid. The government stepped in to help settle the debt in 2021 and as of 2023 company sources said it was once again making profit.

In November 2021, the Energy Community confirmed Ukrenergo had been unbundled in line with EU regulations, greenlighting the certification of the joint stock company as an operator independent of political interference.⁵⁵ Over the years, its sole shareholder has been the Energy Ministry, then the Finance Ministry, then, in 2021, the Energy Ministry once again. As with GTSOU, its return to the Energy Ministry sparked concerns over possible conflicts of interest, as the ministry now owns a company in an industry for which it makes policy.

Ukrenergo's corporate charter calls for a seven-member supervisory board, three of whom must be government representatives. In 2021, its members' three-year terms expired, but before appointing a new panel, the government fired two members of the management board. It was a repeat of the Naftogaz maneuver months earlier and another usurpation of the authority of the supervisory board. Media reports suggested the move was intended to dilute the powers of the CEO Volodymyr Kudrytskyi, considered one of the main reformers of the Revolution of Dignity.⁵⁶

Shortly afterward, the IMF reiterated the need to appoint a supervisory board at Ukrenergo, and the Cabinet did so.⁵⁷ One member stepped down, however, and the board remained without a qualified majority as well as a chairman since 2021 at a particularly ill-timed moment: Ukrenergo had to steward major international donations to repair damage to the electrical grid from targeted Russian attacks, and the company plans to double Ukraine's electricity interconnection capacity with neighboring Hungary, Moldova, Poland, Romania, and Slovakia, which would be a game-changer for Ukraine and the region, boosting security of supply and facilitating the exchange of clean electricity.⁵⁸ At the end of August 2023, the company announced that one of the independent board members had been appointed as chairperson, although the vacancy for the seventh member was yet to be filled. Nevertheless, the appointment of the chairperson could help to sway votes in favour of the independents as the vote of the chair counts twice.

Interviewees said Ukrenergo has performed well recently, despite dire wartime conditions, noting that under Kudrytskyi, Ukraine disconnected from the Russian and Belarusian electricity grids in early 2022, hooking up to the European transmission infrastructure even as war raged.⁵⁹ And despite Russia's systematic attacks, Ukrenergo has been able to tap funds and source replacement equipment to repair damaged infrastructure and even posted a profit in the first half of 2022.⁶⁰

Energoatom

Established in 1996 as a state enterprise, Energoatom generated more than half of Ukraine's electricity before the Russian full-scale invasion. Its installed capacity prior to February 2022 was 13.8 gigawatts spread across the Zaporizhzhia, Rivne, Yuzhnoukrayinsk, and Khmelnytsky nuclear power plants.

In size and role in the market, Energoatom compares with the oil and gas incumbent, Naftogaz. In 2019, just as international financial institutions were pushing Ukraine to deregulate its gas and electricity market, the government required Energoatom to sell 90% of its electricity to end consumers (primarily households) at prices below the market, which led to uncompensated liabilities. The government subsequently reduced the requirement to 50%, with the remaining portion auctioned off,

Ukrainian State Owned Enterprises Net Profits (USD, 2021)



Chart: Center for European Policy Analysis.
Source: Interfax Ukraine, UkrainianNews, and Naftogaz.

sometimes to large, well-connected buyers whose bids were lower than smaller competitors, ultimately costing the company potential revenue.⁶¹

Given the importance of Energoatom and concerns of potential corruption, the IMF set deadlines for the corporatization of the company by December 2021 and the establishment of a supervisory board by May 2022.⁶² Both dates were missed, and in February 2023 parliament finally adopted a law on the corporatization of Energoatom. The process, which involves carrying out an inventory of assets, producing a corporate governance charter, and providing documentation to the securities and exchange regulator, was underway as of June 2023.

Meanwhile, interviewees said the company was expected to settle outstanding debts by mid-July 2023 and complete the corporatization process that but there was no progress reported as of September 2023, and it is unclear whether the government would first seek to select a supervisory board, which would then appoint a new CEO in line with corporate governance principles.

The company will likely remain in the international and domestic spotlight, as it will be at the core of Ukraine's efforts to rebuild its energy sector. The government's recently adopted 2050 vision for the energy industry seeks to expand the country's reliance on nuclear generation, including smaller reactors developed in Western countries such as the US and UK. That will require international financial support, which Western lenders may condition on Energoatom upholding corporate governance rules.

Recommendations

Uprooting systemic corruption and inspiring trust in institutions will be hard, but reforms are feasible.

1. The first, and possibly the most important step, is to **enhance transparency**.

Transparency projects such as DREAM can help civil society and international donors monitor projects, including in the energy sector, from the moment the money is donated until the projects are completed.

Wartime restrictions on reporting key energy market information, such as the level of gas in storage, should be regularly reviewed, and lifted when conditions permit.

DREAM (Digital Restoration Ecosystem for Accountable Management) aims to provide a single platform for tracking all reconstruction projects, improving accountability and transparency.

Launched at the London Ukraine Recovery Conference on June 21, 2023, DREAM is still in the pilot stage but aims to expand as reconstruction efforts gather speed. It will collect data from related platforms, such as ProZorro, for transparent procurement, or the Diia app, which allows citizens to access dozens of Ukrainian governmental services.

Access will be freely available to anyone. Developers hope the system will provide transparent and user-friendly access for international partners who want to track their donations.

Developers are working with the government on legislation that will mandate the reporting of all projects through DREAM by the end of 2023.

Transparency activist Viktor Nestulia, one of the main drivers of the project, is working closely with the government, businesses, and civil society. He said DREAM will position itself not only as a system to smartly plan the reconstruction but also to help coordinate the work of international partners to avoid overlaps.

The energy industry, which has suffered severe war-related damage, will likely be a key beneficiary, although some information on investments there will probably remain confidential to ensure the safety and integrity of infrastructure during the war.



Photo: A massive fire at a Ukraine Armed Forces ammunition depot lights up the sky on the outskirts of Lozovaya town, about 450 km (280 miles) east of the capital Kyiv, August 28, 2008. The fire first broke out in a nearby forest, where high winds prevented the fire services from extinguishing it, and swept into the ammunition dump, the Defence Ministry said. No one had been killed and military families had been evacuated from the area.
Credit: REUTERS/Gleb Garanich (UKRAINE).

The Energy Community's Ukraine Energy Market Observatory, an important tool that provides quarterly updates on legislative changes related to the Ukrainian energy market, should produce more frequent reports. Similarly, *SOE Weekly*, an invaluable newsletter on corporate governance in Ukrainian SOEs that is republished in the *Kyiv Independent*, should be syndicated in more domestic media outlets. Critically, all supervisory boards of SOEs should be required to publish annual performance reports, and members should be asked to declare their salaries. The Naftogaz supervisory board has been publishing such documents, but the board of MGU/GTSOU has issued no reports since 2018, raising questions about its activity and prompting criticism that members have pocketed generous salaries while making no tangible contributions to the gas grid operator.

Finally, the government and the energy regulator should consider providing English-language translations of legal decisions or market reports. Greater transparency would foster better oversight from civil society and international donors while discouraging corruption.

2. The next step is to **improve accountability** across SOEs.

Interviewees pointed out that although Ukraine introduced corporate governance reform in SOEs, no one committed to drive it forward. As a result, neither the National Securities and Stock Market Commission nor the shareholders of SOEs have sought to ensure supervisory board members meet key performance indicators. Regular KPI reviews, therefore, should be introduced, along with meaningful fines for failing to uphold corporate governance standards.

3. Equally important, **corporate legislation needs to be clarified** to avoid arbitrary interpretations of laws.

Laws offer unclear guidance on the application of corporate governance rules, leading to conflicting interpretations on the shareholding structure of SOEs, the appointment and dismissal of CEOs, or the publication of financial reports.

The case of Naftogaz, in which the Cabinet temporarily dismissed the supervisory board and usurped its authority to fire the CEO in April 2021, shows how unclear legislation has allowed rules to be bent.

In addition, interviewees said Zelenskyy appears to be unaware of the importance of corporate governance rules in SOEs and of recent developments that have hindered their implementation. They said the highly respected president would have considerable clout to single-handedly drive the implementation of corporate governance in SOEs if he were sufficiently attuned to the issue, and that Ukraine's international partners should raise it during their meetings with him.

4. The streamlining of corporate law should happen in tandem with the **reform of commercial courts**. A board of independent experts should supervise the appointment of judges in these courts and their performance should be reviewed regularly.

Similarly, considering the importance of fighting corruption as a key condition to Ukraine's EU membership, a panel of independently selected EU judges could be set up to monitor the activity of anti-corruption bodies such as NABU, SAPO, and the High-Anticorruption Court to prevent potential abuses.

5. International financial institutions, which have been supporting Ukraine in recent years, should continue to **condition** the disbursement of funds on implementing corporate governance rules in SOEs.

Finally, it is important to note that even if all of these recommendations are taken up, corruption remains a risk as long as markets are distorted by subsidies, capped tariffs, and heavy-handed regulation.

As long as schemes allow some companies to make undue profit, buying resources at below-market prices and selling them at a premium, the industry will find it difficult to dislodge entrenched rent-seeking practices and inspire faith in SOEs. It is therefore important that corporate governance reform in SOEs happens alongside reform in the wider economy and the energy sector.

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