Validation of Ukraine
Final Validation Report
Adam Smith International Independent Validator
May 23rd 2018

1. EXECUTIVE SUMMARY

The government of Ukraine committed to implement the EITI on 30 September 2009. The Multi-Stakeholder Group (MSG) was formed on 10 October 2012. The country was accepted as an EITI Candidate on 17 October 2013 at the EITI Board's meeting in Abidjan.

On 25 October 2016, the Board agreed that Ukraine's Validation under the 2016 EITI Standard would commence on 1 July 2017. This final Validation report follows on from a quality assurance review of the International Secretariat's initial assessment. The Validator agrees with the Secretariat's preliminary assessment that requirements 2.6, 3.2, 4.1, 4.4, 4.5, 4.9, 6.2 and 6.3 have not met the requirements of the EITI standard.

The Validator also reviewed comments on the draft Validation report from the Ukraine EITI MSG. The MSG did not take issue with or respond to any assessments of specific requirements. The majority of the MSG's comments related to recommendations in the draft Validation report in connection with the most recent EITI report covering the 2016 fiscal year, which was published on 23rd May 2018 and outside the scope of Validation.

The Validator notes these welcome developments, but leaves it to the EITI Board to decide whether to take this updated information into account.

2. BACKGROUND

The extractive sector is a key priority for the Ukrainian government. Although extractives do not account for a particularly large share of economic activity in Ukraine, it is an important source of the Ukrainian government's income, and foreign currency reserves through exports.

The main sub-sector in Ukraine is the petroleum sector. Government revenues in 2015 from petroleum companies, which were reconciled in the EITI Report, accounted for 77% of total reconciled revenues. Coal accounted for roughly 11%, while the metal ores (iron, manganese and titanium) accounted for 12%.

However, in terms of exports and foreign currency earnings, the importance of the sub-sectors shift. Crude oil and coal accounted for less than one percent of total export values. Metal ores on the other hand account for 97% of Ukraine's extractive sector exports – almost 6% of total exports of Ukraine – proving the importance for these sub-sectors to be included in the scope of reporting. Domestically produced gas was not exported during the period.

The coal industry contributes significantly to the government's budget. But the sector is also heavily reliant on subsidies and government programs supporting the companies. This is partly due to the sector employing more than 122 000 people, 56 000 of which are employed by state-owned enterprises, making the sector of high importance for Ukraine's population. Also, there are significant challenges for the sub-sector as a majority of all mines, 57%, are located in the Donetsk and Luhansk regions – the regions which are most central in the on-going conflict between Russia and Ukraine.

Another important sub-sector is the oil and gas transportation system. In 2015 the oil transportation network (operated by the SOE Ukrtransnafta PJSC) transported 15.2 million tons, or 111.4 million barrels of oil. The revenues generated from these activities amount to UAH 3.33 billion or USD 152.4 million. However, the most valuable transportation system is the gas transit network consisting of almost 39 000 km of pipeline. In 2015 it delivered 67.1 billion Sm3 of gas to European countries. This makes the sector an even more important source of economic activity with a value created by its SOE Ukrtransgaz PJSC of almost UAH 25.2 billion (USD 1.15 billion).

However, domestically produced gas was not exported during the period. And as noted previously, the coal sector represents a significant challenge in Ukraine. Therefore, one of the main objectives of the Government of Ukraine (GoU) is therefore to reach energy independence by increasing domestic output and production of electricity, oil, and natural gas and by diversifying its energy supplies. Petroleum production in Ukraine consists of 89% natural gas, 7.9% oil, and 3.1% of gas condensates. The majority of this sub-sector's activities is maintained within three regions; the Dnipro-Donetsk basin, the Carpathian region in western Ukraine, and the Black Sea and Crimea region in the south. The Dnipro-Donetsk basin is a major oil and gas producing region accounting for 90 percent of all current Ukrainian production. The leading position in gas production in Ukraine belongs to the state-owned companies, namely: PJSC Ukrgazvydobuvannya, PJSC Ukrnafta – accounting for 73 percent and seven percent of production respectfully.

The overall economic context of Ukraine has been volatile, following the 2014 Revolution of Dignity. According to the most recent Article IV Consultation performed by the International Monetary Fund (IMF) (IMF, 2017), the economy is now stabilising after a period of high inflation and economic downturn. The consultation also assessed Ukraine's progress towards conditions accompanying IMF's Extended Fund Facility towards Ukraine, of USD 17.5 billion (IMF, 2017). The IMF also mirrors several challenges in Ukraine which relate to the extractive sector. One of these is the existence and participation in state-owned enterprises (SOEs). Although government financing of their main SOE Naftogaz has dropped significantly (to almost zero), there are significant delays in unbundling and privatising SOEs. Another challenge is reducing gas imports. Being a major gas-producing nation herself, Ukraine have started to roll back excessively low gas/heating prices which are beginning to stabilise domestic consumption. The IMF report highlights that prices are now reaching full cost-recovery-levels, and that the next step is to reform a large subsidy-scheme targeting Ukrainian households, as well as accounting for environmental costs in gas pricing. Lastly, the report identifies non-performing loans of companies and SOEs as a major challenge in Ukraine, which creates significant problems for the financial institutions of the country.

In terms of governance, the Resource Governance Index by the Natural Resource Governance Institute (NRGI), Ukraine scores a weak 49 out of 100 points and ranks 44th among 89 countries that were assessed (NRGI, 2017). The index highlights some areas that are particularly challenging, listing contract transparency, tax authority and fiscal rules, and transparency regarding SOEs non-commercial activities. The licensing regime and financial reporting rules for SOEs are also scoring in the mid-range of the index.

Several of these areas are also reflected in country-profiles by the World Bank's Ease of Doing Business index (World Bank, 2017), the World Economic Forum's Competitiveness Report (WEF, 2017) and the Economist's Intelligence Unit (EIU, 2017) as areas of significant concerns. However, the Ease of Doing Business cites on-going improvements enforcement of contracts and minority investor protection (World Bank, 2017). Still, the issue of bureaucracy-levels in Ukraine are listed in all indexes as major challenges for Ukraine's international competitiveness, alongside lack of public disclosures of information.

The government of Ukraine has made several unequivocal statements of its intention to implement the EITI. On 30 September 2009, Prime Minister Yulia Tymoshenko issued Cabinet of Ministers' Resolution N 1098 on joining the EITI (Cabinet of Ministers, 2009). On 12 March 2012, Prime Minister Mykola Azarov appointed the Minister of Energy and Coal Industry (MECI) to be in charge of EITI implementation by issuing Resolution № 230 (Cabinet of Ministers, 2012).

EITI implementation was also included in Ukraine's Open Government Partnership action plan approved by the government's Resolution № 514-p on 18 July 2012. Ministerial Order № 785, signed on 10 October 2012, established Ukraine's multi-stakeholder group (MSG).

The government has continually expressed its commitment through public statements, interviews and events. Prime Minister Volodymyr Groysman in his speech expressed support for mandatory disclosure of extractive revenues under the EITI Standard (UAEITI, 2016a). Members of Parliament Oleksandr Dombrovsky, Head of the Committee of the fuel and energy complex, nuclear policy and nuclear safety, and EITI Board member Olga Bielkova actively advocate for EITI reforms in the country (Dombrovsky, 2016), (Bielkova, 2017). The government's strong commitment was repeated at EITI conferences, press conferences and related events, through public statements and interviews. For instance, at the EITI national conference in February 2017.

Ukraine has participated in OGP since 2011. Implementation of the EITI remains one of the main priorities related to Ukraine's agenda in OGP. The EITI was included in the national Action Plan for 2012-2013 (OGP Ukraine, 2012), 2014-2015 (OGP Ukraine, 2014) and 2016-2018 (OGP Ukraine, 2016).

In line with the Validation Guide, the International Secretariat carried out the first phase of validation—initial data collection, stakeholder consultations, and preparation of their initial evaluation of progress against the EITI requirements (the "Initial Assessment"). Adam Smith International (ASI) was appointed as the independent Validator to evaluate whether the Secretariat's work was carried out in accordance with the Validation Guide. ASI's principal responsibilities as Validator are to review and amend the Initial Assessment, as needed, and to summarize its independent review in this Validation Report for submission to the Board through the Validation Committee.

1) Work Performed by the Independent Validator

The Secretariat's Initial Assessment was transmitted to ASI on March 14th, 2018. Our Validation Team undertook this phase of the Validation process through: (1) In-depth review and marking up of the EITI Assessment by each team member; (2) Detailed review and comments by the Multi-Stakeholder Specialist of Requirements 1 and the Civil Society Protocol; (3) Detailed review and comments by the Financial Specialist of Requirements 4, 5 and 6; (4) Consolidation of reviews and the production of the draft Validation Report, sent to the International Secretariat 5th April 2018; (5) Detailed review of the MSG's comments and the production of the final Validation report, sent to the International Secretariat on 24th May 2018.

2) Comments on the limitations of the Validation

The Validator carefully reviewed the Secretariat's Initial Assessment and at this stage has no comments on the limitation of the Validation process.

3) Comments on the International Secretariat's Initial Assessment

The initial data collection, stakeholder consultations, and drafting of the Initial Assessment were generally undertaken by the International Secretariat in accordance with the 2016 Validation Guide. The data collection took place across three phases. Firstly, a desk review of the available documentation relating to the country's compliance with the EITI Standard, including but not limited to:

- The EITI work plan and other planning documents such as budgets and communication plans;
- The multi-stakeholder group's Terms of Reference, and minutes from multi-stakeholder group meetings;
- EITI Reports, and supplementary information such as summary reports and scoping studies;
- Communication materials;
- Annual progress reports; and
- Any other information of relevance to Validation.

Secondly, a country visit took place on 18-22 September 2017. All meetings took place in Kyiv, Ukraine. The secretariat met with the multi-stakeholder group and its members, the IA and other key stakeholders, including stakeholder groups that are represented on, but not directly participating in, the multi-stakeholder group.

Finally, the International Secretariat prepared a report making an initial assessment of progress against requirements in accordance with the Validation Guide. The initial assessment did not include an overall assessment of compliance. The report was submitted to the Validator, with the National Coordinator (NC) also receiving a copy.

3. GENERAL COMMENTS

- **Progress in EITI Implementation**

Being one of the largest countries in Europe and sovereign for 26 years, Ukraine is still nurturing its democratic practice and rule of law. The country is rich in natural resources; however, internal mismanagement and external interference in the country's integrity result in the extractive sector contributing a relatively insignificant amount to the economy. Ukraine implements the EITI as a part of the country's broader anti-corruption agenda. It is the result of a five-year civil society campaign for Ukraine to join the EITI. After the Revolution of Dignity (2013-2014), the EITI became a part of the government's targeted efforts to tackle corruption and rebuild citizens' trust. It became a crucial tool for transparency of the extractive industries.

The government uses the EITI to enhance the country's image, raise its credit rating and attract quality foreign investment. EITI reporting contributes to shaping Ukraine's strategy on advancing the management of the extractive industries. Despite ongoing reforms on e-governance and open public access to the information, the EITI remains the only mechanism for disclosing the revenues from mining, oil and gas, and from transportation. The EITI process has evolved rapidly by expanding its scope to coal, manganese and titanium mining; increasing the number of reporting companies; and providing more disaggregated revenue data.

EITI implementation has complemented broader economic, financial and institutional reforms, in particular by adopting a law on "Transparency in the Extractive Industries", and by amending a law on "State Registration of Legal Entities and Individual Entrepreneurs" and a Law "Budget Code". Another strength of Ukraine's EITI implementation has been its success in using the process to address local concerns, both through active dissemination and outreach efforts and by providing a platform for an informed public debate.

- **Impact of EITI Implementation**

EITI has led to tangible impacts through government reforms, increased engagement of the extractive companies and greater awareness by host communities of their rights. For instance, the government introduced changes to the Budget Code that enabled five percent of production royalties from oil and gas companies to be transferred to the local communities. UA EITI spearheaded efforts to facilitate dialogue on the new legislation between various stakeholders, including the Ministry of Finance, the State Fiscal Service, the State Treasury, local authorities, local communities, and extractive companies. This dialogue, which was open and publicly-accessible, discussed practical applications of the new legislation with a focus on the benefits for local communities. The EITI contributes to developing regulation and transparent reporting mechanisms for allocation and use of subnational revenues.

Due to joint efforts of MSG members the legal framework for EITI reporting was adopted. In particular, Law No.521-VIII on "Amendments to Certain Legislative Acts of Ukraine on Ensuring the Transparency in the Extractive Industries", Cabinet of Ministers Order No. 910-r on "Action Plan for the Implementation of the Extractive Industries Transparency Initiative" and Cabinet of Ministers Resolution No. 1039 on "Approval of the Procedure on Ensuring Transparency in the Extractive Industries". The MSG has also initiated development of draft Law 6299 on "Transparency in the Extractive Industries" that has already been submitted to the Parliament.

Aspects of the EITI Standard are particularly pertinent to some of Ukraine's key challenges and sources of past public controversy. Requirements of the EITI Standard related to clarifying the production data, transportation revenues, financial relations between state-owned enterprises and the government, contract transparency, social expenditures, subnational transfers and audit practices all touch upon issues that stakeholders consider sensitive. The EITI Standard provides a unique opportunity to address these issues.

The Independent Validator's Assessment of Compliance

Figure 1 – Validator's assessment

EITI Requirements		LEVEL OF PROGRESS				
Categories	**Requirements**	No progress	Inadequate	Meaningful	Satisfactory	Beyond
MSG oversight	Government engagement (#1.1)				■	
	Industry engagement (#1.2)				■	
	Civil society engagement (#1.3)					■
	MSG governance (#1.4)				■	
	Work plan (#1.5)				■	
Licenses and contracts	Legal framework (#2.1)				■	
	License allocations (#2.2)				■	
	License register (#2.3)				■	
	Policy on contract disclosure (#2.4)				■	
	Beneficial ownership (#2.5)					■
	State participation (#2.6)		■			
Monitoring production	Exploration data (#3.1)				■	
	Production data (#3.2)			■		
	Export data (#3.3)				■	
Revenue collection	Comprehensiveness (#4.1)			■		
	In-kind revenues (#4.2)					
	Barter agreements (#4.3)					
	Transportation revenues (#4.4)			■		
	SOE transactions (#4.5)		■			
	Direct subnational payments (#4.6)					
	Disaggregation (#4.7)				■	
	Data timeliness (#4.8)				■	
	Data quality (#4.9)			■		
Revenue allocation	Distribution of revenues (#5.1)					■
	Subnational transfers (#5.2)				■	
	Revenue management and expenditures (#5.3)					
Socio-economic contribution	Mandatory social expenditures (#6.1)					■
	SOE quasi-fiscal expenditures (#6.2)		■			
	Economic contribution (#6.3)			■		
Outcomes and impact	Public debate (#7.1)					■
	Data accessibility (#7.2)					
	Follow up on recommendations (#7.3)				■	
	Outcomes and impact of implementation (#7.4)				■	

Legend to the assessment card

	No progress. All or nearly all aspects of the requirement remain outstanding and the broader objective of the requirement is not fulfilled.
	Inadequate progress. Significant aspects of the requirement have not been implemented and the broader objective of the requirement is far from fulfilled.
	Meaningful progress. Significant aspects of the requirement have been implemented and the broader objective of the requirement is being fulfilled.
	Satisfactory progress. All aspects of the requirement have been implemented and the broader objective of the requirement has been fulfilled.
	Beyond. The country has gone beyond the requirement.
	This requirement is only encouraged or recommended and should not be taken into account in assessing compliance.
	The MSG has demonstrated that this requirement is not applicable in the country.

4. DETAILED FINDINGS

This Validator agrees with the findings of the Initial Assessment and requires no further clarification.

5. RECOMMENDATIONS

1. To further strengthen implementation, the government is encouraged to remove any obstacles that the anti-corruption amendments might imply on the civil society operation.

2. To further strengthen implementation, the government is encouraged to institutionalise mandatory reporting for the mining industry in order to avoid reporting challenges in the future.

3. To further strengthen implementation, the MSG could consider further entrenching EITI funding in government budgeting.

4. To further strengthen the timeliness and relevance of the information, MSG and the Ukrainian government are encouraged to explore possibilities to collate and disclose information regarding the legal and fiscal framework of Ukraine online, enabling timelier and more regular updates to reflect the current context in Ukraine's extractive sector.

5. In accordance with requirement 2.2.a, the government should ensure annual disclosure of the technical and financial requirements for licenses awarded and any non-trivial deviations from the applicable legal and regulatory framework governing license awards and transfers.

6. To provide more relevant and concrete recommendations for how to improve Ukraine's licensing system, it is also recommended that the MSG considers performing additional analyses concerning the efficiency and effectiveness of the existing procedures for allocating extraction and prospecting rights in Ukraine.

7. The MSG and Government of Ukraine are encouraged to explore possibilities for providing license registry information in open data formats, such as CSV or Microsoft Excel, to improve data accessibility and to simplify data collection related to EITI reporting.

8. The MSG is recommended to explore further the government's policy on contract transparency and document the findings in future EITI Reports. The MSG and Government is encouraged to continue its efforts towards ensuring contracts are disclosed as is recommended under Requirement 2.4.

9. To strengthen implementation and prepare for full disclosure of beneficial ownership information by 2020, it is recommended that Ukraine EITI considers conducting broader outreach to the companies on the objectives of beneficial ownership transparency, as well as to hold conversations with government agencies on how to make such information accessible in open data formats. The MSG is also encouraged to ensure progress in implementing the beneficial ownership roadmap is documented in EITI Reports. The MSG and GoU are encouraged to explore opportunities for increased data accessibility; that beneficial ownership information is made available in open formats.

10. In accordance with requirement 2.6.a, the MSG should provide a comprehensive overview of state-owned enterprises, including an explanation of the prevailing rules and practices related to SOEs' retained earnings, reinvestment and third-party funding. The government should also ensure annual disclosure of any changes in

government ownership in SOEs or their subsidiaries, and provide a comprehensive account of any loans or loan guarantees extended by the state or SOEs to mining, oil, and gas companies in line with requirement 2.6.b.

11. In line with Requirement 3.2, the MSG should ensure that future reports disclose the production values for every extractives commodity produced, including crude oil, natural gas and every mineral covered by reports. To continue improving on the requirement, the MSG may wish to comment on parallel reporting systems for production volumes including regular publication and verification procedures, to ensure consistent, regular and reliable data.

12. The MSG should ensure that full government disclosure is clearly presented by separate entity and revenue stream.

13. The MSG should ensure that the IA includes a clear assessment of the comprehensiveness of the next EITI Report, that discrepancies are explained and investigated where necessary.

14. The MSG should ensure that the next report disaggregates the transportation revenues by pipeline/route and by paying company.

15. As per Requirement 4.5, the MSG should engage relevant government entities and SOEs with the view to ensure that the reporting process comprehensively addresses the role of state-owned enterprises (SOEs), including material payments to SOEs from oil, gas and mining companies, and transfers between SOEs and other government agencies.

16. The MSG is recommended to engage relevant government agencies to ensure an overview of state ownership is accessible and regularly updated. Related to such an overview should also contain the general governing principles of managing SOEs', in addition to specific information for SOEs in the extractive sector.

17. To strengthen implementation, the MSG may wish to add a clear explanation on the government entity, that collect all tax and non-tax revenues in Ukraine.

18. The MSG should insure that the next EITI Report includes an overview of progress on addressing the recommendations from the previous EITI reports.

19. The MSG should ensure that the Independent Administrator provides an assessment of comprehensiveness and reliability of the (financial) data presented, including an informative summary of the work performed by the Independent Administrator and the limitations of the assessment provided.

20. The Independent Administrator's inception report should document the options considered and the rationale for the assurances to be provided.

21. The MSG should ensure that the next EITI Report includes an assessment of omissions and if any omissions had material impact on the comprehensiveness and reliability of the report.

22. The next EITI Report should include the IA's opinion regarding that reconciliation, including discrepancies.

23. The MSG should ensure that the confidentiality provisions are clearly agreed and explained.

24. To strengthen implementation, the MSG may wish to consider providing detailed explanation of the formula used for allocation of subventions in the EITI Report.

25. To strengthen implementation, the MSG may wish to further investigate the nature of discrepancies between the budgeted amounts and executed transfers.

26. The MSG is encouraged to publicly clarify the existence of the mandatory social payments.

27. In line with Requirement 6.2, the MSG should clarify a definition of materiality with regards to quasi-fiscal expenditures by SOEs, including SOE subsidiaries and joint ventures. The MSG should ensure disclosure of quasi-fiscal expenditures are according to requirement 6.2. This includes the nature of the subsidy scheme for household utility-payments, and the role of state-owned enterprises. It also includes the financial relationship between the SOE and its subsidiaries, including joint ventures, especially pertaining to coverage of losses.

28. To further ensure disclosure is comprehensive, the MSG may wish to define which expenditures are of a quasi-fiscal nature using national laws and regulations, e.g. as defined by order no. 692 of the Cabinet of Ministers of Ukraine.

29. The MSG should clarify the availability of, and estimate, informal sector activity. This includes but is not necessarily limited to artisanal and small-scale mining, as per Requirement 6.3.

30. To further strengthen implementation, the MSG may wish to consider undertaking an impact assessment, in order to determine the extent to which the EITI has contributed to improving public financial management and governance of the mining, oil and gas sectors.

31. To further strengthen implementation, the MSG in consultation with the government should follow-up to act on lessons learned, to identify, investigate and address the causes of discrepancies

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