

**OIL AND GAS SECTOR OF UKRAINIAN ECONOMY:  
TRANSPARENCY OF FUNCTIONING AND REVENUES**  
(summary of the Project “Oil & Gas Revenue Transparency” results)

**1. Project positioning**

Non-transparent functioning of the oil and gas sector of Ukrainian economy and the energy transit infrastructure in Ukraine during the entire period of independence since 1991 results in the shadow redistribution of financial flows. It has adverse impact on budget revenues, generates non-transparent methods of running energy business, and contributes to corruption and instability. Without proper level of transparency Ukraine, with all her geoeconomic advantages and transit potential, drifts into the “grey zone” of risky transit. Both Eastern and Western partners will try to avoid it. This trend is already manifesting itself quite vividly. To Ukraine, with her gas and oil transportation systems, the present transit in the East – West direction and prospective transit in the South – North direction has the same fundamental importance as energy resources for countries extracting them.

**2. Basic project determination**

In the beginning of Project implementation process we made methodological research, particularly concerning applied definition of transparency. *Transparency of relations in the oil and gas sector constitutes its multi-aspect state (property) of reporting to the society by authorities on the regular basis, when every individual has free access to the necessary information in order to assess the level of efficiency of using national mineral resources and national assets which said individual co-owns and had authorized government authorities to manage.* Transparency is characterized by availability of constantly circulating and accessible information flows which ensure sufficient level of awareness of the society and also public control over activities of government agencies and companies, and possibility of verifying the data to confirm objectiveness and correctness of information provided to the public. A complex of legislative norms which ensure transparency constitutes basic element of transparency in a democratic state governed by the rule of law and sharing principles of an open society.

**3. Project orientation**

The goal of the project is to indicate zones of non-transparency with subsequent assistance in introducing the concept of “transparency” to the legal environment and its implementation in the legal practice using appropriate legal instruments. The latter must be supported by a number of legislative initiatives in order to bring Ukrainian law which deals with these matters into conformity with norms generally accepted in the EU. This approach is in agreement with Ukraine’s strategy of European integration. Provisions of directives, regulations, resolutions, and recommendations of the EU, criteria of the International Energy Agency, approaches of the Energy Charter Secretariat described in the Project may be selected as models. The need in creation of a unified statistical base in the country which would have been complementary to the Statistical Office of the European Communities (Eurostat) becomes a priority issue. Another, but not less important priority is transition to the development of Ukraine’s energy balance based on the IEA methodology.

**4. Indication and decryption of the “black box” of gas business**

In course of the project we indicated the zones of non-transparency, particularly in the most resonance-sensitive gas trade sector. We secured access to the constituent documents of RosUkrEnergo (RUE) and its base contract with Naftogaz Ukrainy NJSC. It allowed us to assess the scale and consequences of functioning of the installed system of gas business conditionally named the “black box”. The total volume of gas contracted by RUE on 29 July 2004 corresponds to the amount of contract which Gazprom signed with Turkmenneftegaz on 10 April 2003, and is equal to **1,337 billion cubic meters** during 24 years when this contract will be in effect (until 2028). Financial flow generated by the contract reached approximately **US 210.4 billion** in 2007 prices. The profit is distributed as follows. 50% goes to Gazprom (via Gazprombank) as a co-founder of RUE. As far as “Ukrainian” half is concerned, formally profit goes to two private individuals in the 45% + 5% proportion. Therefore, profit generated within RUE framework by using potential of Ukrainian gas transportation system and underground gas storage tanks which belong to the state is redistributed in favor of private individuals and does not work to the benefit of Ukrainian society.

Here is how the scheme of non-transparent transnational gas business works. At the input to the system is Central Asian gas resource, and at the output located in Swiss canton Zug is the cash flow non-transparently redistributed between shareholders. Financial resources circulating beyond government and public control represent an extraordinarily serious potential of, particularly, corruption nature. Registration of the company in Swiss canton Zug means that its activities cannot be controlled by any competent authorities of Ukraine, the Russian Federation, or the EU. At the decision of the company's management funds may be channeled to the accounts of different individuals and legal entities and also officials, private funds, and research centers in order to solve certain tasks and for the purpose of legitimization and preservation of non-transparent gas trading scheme for the duration of the aforementioned contracts. Specific features of the companies like RUE are revealing, which is proven by the constituent documents. One thousand RUE shares may be transformed from registered into bearer shares and vice versa. It opens broad possibilities for their non-transparent circulation in the interests of real owners. According to the Swiss Federal Code of Obligations, registered shares may be transferred without any restrictions upon company's consent. At the same time, consent is considered granted if company does not raise objections during 3 months after receiving relevant application.

Financial result of RUE's gas trading scheme had sharply increased after creation in 2006 of a joint venture of RUE and Naftogaz Ukrainy NJSC named UkrGazEnergo (UGE). Practically, the RUE-UGE scheme became an instrument of capturing domestic gas market in Ukraine. Attempts of the current government to liquidate this non-transparent scheme resulted in mobilization of administrative, lobbyist, financial resources of RUE and its shadow affiliated structures to resist government plans. The RUE-UGE tandem used its connections in Gazprom and the leadership of the Russian Federation in order to initiate the "gas war" scenario as it happened first at the beginning of 2006 and then in February-March 2008.

Analysis of events which took place in Yalta on 26 July 2004 with subsequent signing of the package of gas agreements at Gazprom office in Moscow on 29 July showed that not only the gas trading scheme was upgraded considering business interests of certain politicians but at the same time strategical priorities of Ukraine were corrected. It is probable that it was a package approach on part of the Russians devised for a long-term period (until 2028). Financial potential of the RUE scheme and extensive network of lobbyist-corruption communications allows Russian party actively influence the branches of power in Ukraine, manipulating them and receiving, as a result, strategical concessions.

## **5. Assessment of existing level of transparency according to Ukrainian law currently in force**

Based on the studies conducted within the Project's framework we can draw the following general conclusions concerning legislative guarantee of the level of transparency in relations in the oil and gas industry of Ukraine:

- guarantee of transparency in relations in the oil and gas industry does not belong to the legislatively determined principles of the state policy, and informing the public about the state of affairs in this industry is not mentioned among the tasks of government regulation of relations in the oil and gas sector;
- individual rights in the oil and gas industry provided by Ukrainian law are fragmentary, do not form a single clear system, and do not ensure sufficient level of information about the state of affairs;
- Ukrainian law establishes mechanism of government control over business activities in the oil and gas sector; however, it does not provide directly for the involvement of public representatives in carrying out the government control and does not establish obligation of government authorities to inform the public about results of carrying out said control;
- Ukrainian law does not provide for a complex mechanism which would have determined the object, subjects, and mechanism of public control in the oil and gas industry.

## **6. Recommendations**

Transparency will have decisive importance for Ukraine in retaining its energy transit potential in the East – West direction which became endangered due to a number of factors, with non-transparency of functioning of the oil and gas sector of Ukrainian economy being not among the least important of them.

The Verkhovna Rada of Ukraine and the Government of Ukraine should come out with the initiative of revealing to the society the actual amount of revenues, expenditures, tax paid to the budget, indirect taxes, deductions to non-budget funds, sponsor donations, loans received, and liabilities of Naftogaz Ukrainy

NJSC, and long-term contracts signed during the entire 10-year period of existence of this monopolistic structure.

While the nation's transit potential hadn't been completely exhausted it might be expedient to consider creation of a special non-budget fund where part of revenues received by the oil and gas sector would have been paid, being allocated not for the current budget decumulation but for the investments in the increase of energy efficiency of the economy, growth of energy transit potential, development of prospective energy resource deposits. This fund must be under control of the parliament only and be transparent for the public society.

A "partnership triangle": Government – Oil and Gas Sector Companies – Alliance of Non-Government Organizations is long due as well, in which the latter, along with the mass media, will maintain public control over performance of government agencies and business entities.

The Government of Ukraine and the European Commission negotiating the signing of a new treaty between Ukraine and the EU shall provide for a special clause on ensuring transparency of energy transit flows coming through Ukraine.

Creation of the Metrological Center in Boyarka and equipping of eastern and northern sections of the state border with gas metering stations and oil metering units will have indicative importance for the EU and Ukraine.

Creation of strategic oil reserve in form compliant with the OECD/IEA criteria should also become a necessary step towards more transparent functioning of the oil industry in Ukraine.

Transparency of prices and tariffs on fuel and energy resources imported to Ukraine may also be ensured if the same level of transparency will be maintained in the exporting countries. It is a necessary yet not sufficient condition. Therefore, it seems expedient to come up with the initiative to implement a project of establishing a transcontinental transparency along the "upstream – midstream – downstream" chain. The IEA or the Energy Charter Secretariat could become the epicenter of this initiative. It is extremely important in light of the fact that energy resources become more and more an instrument of political influence, in a way an energy weapon.

It might be expedient to create a national Internet resource containing complete register of operators in the energy industry, broken down by sectors. Transparentization (some sort of lustration) of operators, especially those involved in the non-transparency of performance of the oil and gas industry or their legal successors, seems to be expedient as well. If, as a result of such transparentization it will be discovered that part of the revenues of the oil and gas market operators was generated due to inadequate tariffs and prices, it would warrant special investigation with the appropriate financial or material sanctions if the abuse will be proved.

Transparency of contracts, tariffs, and prices is especially important. In this context, the Energy Charter Secretariat recommends Estonian experience where the Council for Protection of Consumer Rights was created to perform the functions of a public supervisory organization protecting consumers at the lower level.

Non-transparency of payments from company budgets and the state budget revenues received from taxpayer entities operating in the oil and gas sector constitute a serious problem. In this context, the *Publish What You Pay, Publish What You Receive* initiative (<http://www.publishwhatyoupay.org>; <http://revenuewatch.org>) is worth attention. Implementation of this approach allows to minimize corruption-related pressure on the business and maximize the level of public trust in government structures (fiscal authorities first of all) and monopolist companies.

Extension of transparency projects to other sectors of Ukrainian economy – coal mining, ore mining (iron ore and uranium ore mining), power industry (thermal power engineering, nuclear power engineering), transportation (railroads, seaports) – is also important.

It seems expedient for non-government organizations, especially those at the regional level, to form coalitions (alliances) in order to establish control of public society structures over the use of mineral resources and power and transport infrastructure (particularly, regional distribution networks – oblast power (oblenergo) and gas (oblgaz) distribution companies) through implementation of appropriate monitoring projects. In this context, cooperation with the mass media becomes very important. It seems expedient for journalists to unite into informal networks (investigator journalist networks) to conduct relevant thematic research (investigation). It may give necessary impulse to public society structures and force government authorities to act in the national interests, liquidating non-transparent corrupted schemes of using national resources in the interests of a narrow circle of corrupted politicians and oligarchs.

## **7. Project actions**

On 5 September, during XVII Economic Forum in Krynica Górská, the Project Coordinator with the support of the Institute of Eastern Studies, Republic of Poland had organized the *Energy Monopoly – Challenges to Europe* discussion seminar. The Project Coordinator had also participated in the number of international expert conferences, such as:

- *Oil and Gas in the Fate of Russian-Ukrainian Relations* round table, Kyiv, 18 October 2007;
- II Energy Forum, Prague, 4-6 November 2007;
- *Ways of Reaching Energy Independence in Ukraine* round table devoted to reformation of gas industry, 21 November 2007, Embassy of Poland to Ukraine;
- I Spanish-Ukrainian seminar in Barcelona, 3-4 December 2007.

A seminar for journalists was held in Kyiv on 14 December 2007 with participation of representatives of the Secretariat of the Cabinet of Ministers of Ukraine, Secretariat of the President of Ukraine, and academic staff of the International Institute of Management.

A series of interview meetings was held with the management of foreign oil and gas companies operating in Ukraine, in order to get indication of how foreign companies assess the state of transparency in oil and gas industry of Ukraine.

At the invitation of the Committee for Economic Policy of the National Council of the Slovak Republic on 6-9 November 2007 we went to Bratislava to learn about experience of Slovak party in ensuring transparency of functioning of the oil and gas sector. We engaged foreign experts from the Republic of Poland and the Slovak Republic in preparation of parts of the conclusive report.

## **8. Possible areas of further development of the Project (NOMOS recommendation for IRF)**

As a result of implementation of the Project it could have been desirable and expedient in the long-term prospective to transform it into a number of other projects in development of the following:

### ***"Horizontal" development***

- Creation of network of expert journalist investigation in the energy sphere (continental shelf production, laying of the Southern Flow, etc.)

### ***"Vertical" development***

- Development of draft legislations based on existing recommendations of the expert group (adaptation of the EU norms into Ukrainian normative and legislative base)
- Circulation of financial flows of the oil and gas industry in the context of budget policy
- Transparency in activities of regional gas supply companies (oblgaz)

### ***International format***

- A transnational project of transparency of transit pipeline systems supplying hydrocarbon resources (Central Asia – Russian Federation – Ukraine – European Union, Caspian Sea – Southern Caucasus – Black Sea – Ukraine – European Union)

Extension of transparency projects to the following sectors of Ukrainian economy would have been very important:

- coal mining;
- ore mining (iron ore and uranium ore mining);
- power industry (thermal power engineering, nuclear power engineering);
- transportation (railroads, seaports).