

# Ukraine Politics Update

Key reforms, IMF cooperation stall heading into summer

## Government dallies on IMF-mandated reforms

IMF Country Representative Max Alier said last week Ukraine needs to pass financial and pension reform before talks can resume on its loan program. A scheduled USD 1.5 bln tranche was to have been disbursed in March. Following the last visit by an IMF mission back in February, Ukraine and the IMF agreed to a softer phase-in to gas tariff increases, +30% in 2011, vs. +50% envisaged in prior agreements. A controversial pension makeover (including raising the retirement age for women to 55 by 2020) has yet to be brought up in parliament for a discussion. The government has firm control over parliament to push through its planned bills, but given the lack of momentum, we are starting to feel skeptical about progress in these next few weeks before parliament heads off on summer break. At the same time, we maintain our view that the perceived risk of delays in IMF cooperation to the sovereign credit profile are overblown.

## Summer of discontent?

While the government has been understandably leery of pushing too hard on the reform peddle, hoping to avoid a black eye like the pushback surrounding its tax reform in fall 2010, we have also seen little activity to involve critics on developing more palatable solutions. The average Ukrainian remains disengaged: the opposition has so far mustered only small rallies (from a few hundred to a thousand, according to media reports). Meanwhile, President Viktor Yanukovich's approval ratings have fallen sharply to 11.3% in April, from a peak of 40.9% exactly a year earlier.

## Privatization, IFRS transition, currency liberalization move ahead

Despite the lack of progress on mainline IMF reforms, Ukraine is moving head in key areas closely watched by investors, including on its denationalization program, finalizing the sale of incumbent fixed-line telecom operator Ukrtelecom in March and clearing the way for electric utilities (namely Dniproenergo and Zakhidenergo) to hit the auction block later this year. In addition, parliament approved a law requiring public companies, banks and insurers to prepare annual IFRS financials starting in 2012. One other key piece of legislation to watch is a draft bill registered by parliament last month with several measures to liberalize the domestic currency market, including the introduction of currency swaps.

**Report date** **24 May 2011**

### Politically sensitive stocks

Centrenergo (CEEN UK)	Privatization
Dniproenergo (DNEN UK)	Privatization
Donbasenergo (DOEN UK)	Privatization
Ukrnafta (UNAF UK)	Corp. conflict/LSE listing
Zakhidenergo (ZAEN UK)	Privatization

*Note: We highlight these stocks as potentially the most sensitive to political factors in 2011*

### Key reform issues for 2011

- Pension reform
- Oil & gas sector reform
- Electricity sector reform
- Labor code reform
- Cont. of tax reform
- Privatization

### Ukrainian presidential approval ratings

Response	April 2010	April 2011	Chg, y-o-y
Fully support	40.9%	11.3%	-29.6 pp
Support certain actions	25.4%	35.5%	+10.1 pp
Do not support	28.5%	47.6%	+19.1 pp
Difficult to answer	5.2%	5.6%	- 4 pp

*Source: Razumkov Center survey (April 1-5, 2011, 2,009 respondents, margin of error: ±2.3)*

## Reform monitor

Below is a brief overview of the government's progress on its reform agenda for 2011, status of key legislation and our best guestimate of a likely implementation timeline.

Sector	Status	Likely timeline	Notes
<b>Pension reform</b>	<b>stalled</b>	<b>2H11</b>	Ukraine, in its November 2010 memorandum and in ongoing talks with the IMF, committed to overhauling the pension system. Key tenants include ensuring a balanced budget for the fund by increasing revenues through tax reform and improving payment of contributions, and raising the retirement age for women gradually over 10 years to 55 by 2020 (on par with males). The main law currently regulating the pension system dates back to 2001.
<b>Oil &amp; gas sector reform</b>	<b>ongoing</b>	<b>2011-?</b>	The government has made some progress in shoring up the position of Naftogaz of Ukraine already this year. It plans to increase gas prices for households and utilities by another 30% this year (following a 50% hike in August 2010), fully pass through higher gas prices to utility prices, and establish tighter control over operational costs. The makeover of Ukrnafta is shaping up to be another big story – a new CEO was voted in this quarter and plans are afoot to create a vertically integrated structure by merging it with refiner Ukrtatnafta.
<b>Continuation of tax reform</b>	<b>pending</b>	<b>2H11</b>	Government officials claim that the new tax code passed last year will streamline legislation and help tackle tax evasion – the phase-in period began as of January 1, and the State Tax Administration and Finance Ministry have begun issuing supplemental guidance on new provisions. In addition, the government aims to clear VAT arrears in 2011 and setup a new systematic and timely VAT refund process.
<b>Privatization</b>	<b>ongoing</b>	<b>ongoing</b>	After finalizing the privatization of Ukrtelecom on March, the State Property Fund is under pressure from the government to continue denationalizing key state assets. The government has removed remaining obstacles to auctioning off power generation companies and the Odesa Portside plant in 2011. An auction is expected to be announced for either Zakhidenergo or Dniproenergo anytime now, with the other hitting the block later this year. State-owned stakes in several Oblenergos could also be privatized this year.
<b>Electricity sector liberalization</b>	<b>pending</b>	<b>2012</b>	Long-awaited sector reform (liquidation of the one-pool model and move to bilateral contracts with a balancing market) is now looking like a possibility for 2012 following the privatization of both Zakhidenergo and Dniproenergo, in order to spur further interest from strategic investors in other state-owned assets. With electricity prices high, the government should be motivated to effect the reforms necessary to create a more efficient generating and pricing structure.
<b>Land reform</b>	<b>pending</b>	<b>2012-2013</b>	The sale of agricultural land is possible after parliament adopts bills on establishing a land cadastre and land market. The moratorium on land sales has been in effect since 2002. Relevant laws were registered by parliament in April. President Yanukovich said in March he favored passage of the bills by midyear and there are indications that other key officials in the Yanukovich government favor land reform in the near term.
<b>IFRS transition</b>	<b>approved</b>	<b>2012-2014</b>	This month the Rada approved a law that requires public joint stock companies, banks and insurers to prepare annual IFRS reports starting in 2012. According to our sources, only about 25 Ukrainian companies released public IFRS accounts for 2010, most of which were listed on an international exchange (London, Warsaw, or Frankfurt) or banks. The transition to IFRS by Ukrainian companies listed domestically is a significant step forward in improving the transparency and clarity of financial reporting in the country, though we note delays in implementation are very likely due to the time necessary for training and updating of corporate internal accounting systems.

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