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# Ukraine Strategy

## All eyes on the Rada voting on Cabinet initiatives on July 31

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**At its July 31 session, Ukraine's parliament, the Verkhovna Rada, will consider the government's initiatives on amendments to the 2014 state budget and tax code (reallocating funds and creating new revenue sources). Approval of the initiatives will secure higher budget revenue to compensate for the expected revenue underperformance due to falling economic activity, as well as satisfy the need for higher budget spending for the Ukrainian army and restoration work in the war-afflicted Donbas region.**

**More importantly, the adoption of the initiatives will open the door to a positive decision by the IMF board on disbursing the second tranche of a loan (expected in the second half of August) and securing the financing for all Naftogaz's needs (including a USD 1.6 bln Eurobond repayment in September). This should have a positive effect on sovereign debt and Ukraine's currency. A successful vote for all the Cabinet's initiatives will have a negative financial effect on private gas producers and some negative effect on domestic farmers, grain traders and iron ore miners.**

**Probability of successful vote looks higher this time**

Last Thursday, the government failed to persuade two of the three factions of the parliamentary coalition to vote in favor of its initiatives. We see the failure as the Cabinet's fault – its ministers assumed by default that parliament will welcome all its proposals. Instead a majority couldn't be mustered even to include new tax initiatives into the session's agenda (falling short by 20 votes).

Parliament's failure resulted in a resignation announcement declared by Prime Minister Arseniy Yatsenyuk (which is unlikely to be satisfied). The interim crisis caused local currency weakening by 4.2% in four days and an increase in Ukraine's five-year CDS level by 30bps to 829bps.

Thus far, a positive outcome on July 31 hasn't been secured. What is being reported so far is that Cabinet members are working hard with MPs to address concerns on the bills and persuade them to vote in favor. Such adjustment from last week's draft include a decreased royalty on gas production (reducing it from a proposed 70% of the regulated gas price to 55%, resulting in a 2.8x yoy increase in the royalty to be paid vs. a 3.5x yoy increase), which would be compensated by a higher royalty payment on iron ore (rising to 8% of the market price from 5%).

Given the government's efforts and the MPs' better awareness of the possible negative consequences of the initiatives' failure, we believe that the Rada will vote in favor this time.

**Failure to approve the Cabinet's initiatives on July 31** may exacerbate the current crisis, with limited time to correct it. The next Rada session is scheduled for August 12, when it might be too late to approve the initiatives needed to satisfy IMF demands. However, an extraordinary meeting of MPs might be scheduled sooner in case the July 31 votes prove fruitless.

The negative consequences are:

- Not necessarily will it lead to the IMF's rejection of a new tranche, but it will certainly decrease its likelihood (we do not know the exact commitments that Ukraine took during the IMF's review this month). Needless to say, this would increase risk of Ukraine's sovereign default.
- It might also initiate a new wave of government crisis and result in an even deeper devaluation of the local currency.
- Moreover, a Naftogaz default on its Eurobond will become much more likely. On the flip side, the Rada will have two more months to secure needed budget financing.

# If the legal initiatives are approved

**Positive effect on Ukraine's risk, currency**

As the adopted initiatives will secure financing of most of the budget needs for the rest of the year and ensure further loans from the IMF and other international creditors (all of them are sensitive to the IMF's decision), we expect a decrease in Ukraine's CDS and downward movement of Ukraine's sovereign bond curve. On top of that, we also expect the Ukrainian currency to strengthen.

**Naftogaz Eurobond: very positive**

The draft amendment to the 2014 state budget stipulates an increase in Naftogaz's charter fund by UAH 96.7 bln this year (vs. UAH 33.4 bln increased, so far). This is a slight decrease compared to last week's initiative (total contribution of UAH 103.4 bln). The capital increase, as usual, should be done with a contribution of government bonds. The total contribution will be more than enough to cover all of Naftogaz's payments this year, including a USD 1.6 bln Eurobond repayment scheduled for late September. The approval of the amended state budget will, therefore, secure a smooth repayment of the NAFTO Eurobond.

**Private oil & gas producers: very negative**

The revised amendments stipulate that the total increase in oil & gas royalties will result in extra budget revenue of UAH 4.8 bln by the year's end (vs. UAH 9.0 bln, as stipulated by the draft law filed last week). Independent oil & gas producers will have to pay UAH 2,598/tcm in royalties if the law is approved (vs. an average payment of UAH 816/tcm last year and UAH 807/tcm paid in 1H14). For new wells (to be introduced after August 1, 2014), the tax will be 1.8x smaller for the first year of their operation.

This will lead to an average decrease in gas producers' netback by about 2.0-2.5x yoy, compared to a 4.0-4.6x decrease if last week's initiative had been approved. Clearly, the effect of new legislation on independent gas producers – Serinus Energy (SEN PW), JKX Oil & Gas (JKX LN), Regal Petroleum (RPT LN) and Cadogan Petroleum (CAD LN) – will be negative, though it could have been worse.

**Gas extraction tax summary (estimated)**

| | 2013 | 1H14 | Aug.'14 on (old draft) | Aug.'14 on (new draft) |
|---|---|---|---|---|
| **SEN PW, JKX LN, CAD LN:** | | | | |
| Royalty, UAH/tcm | 816 | 807 | 3,307 | 2,598 |
| % of achieved gas price | 24% - 26% | 23% - 25% | 72% - 75% | 56% - 59% |
| **RPT LN:** | | | | |
| Royalty, UAH/tcm | 457 | 432 | 3,307 | 1,323 |
| % of achieved gas price | 14% | 12% | 74% | 29% |

*Source: Company data, Verkhovna Rada, Concorde Capital estimates*

**Iron ore miners: negative**

Tax code amendments made public on July 30 foresee an increase in the extraction tax for iron ore to 8% from 5% of its market price (valid since April 2014). Its approval will increase taxation of Metinvest (METINV), its iron ore subsidiaries and Ferrexpo (FXPO LN) to USD 7 to USD 8 per ton of iron ore from USD 5/t valid since April 2014 and USD 1/t in 2013-1Q14.

**Agricultural sector: slightly negative**

As with last week's initiative, the new tax code amendments foresee that grain exporters will not be eligible for reimbursement of their VAT in 4Q14 (in addition to 2Q and 3Q, as approved earlier by the Rada). The Cabinet expects to save extra UAH 1.8 bln from this initiative. Grain exporters will likely pass some of these costs onto farming companies, likely in the form of an extra quarter of lower domestic crop prices.

# Proposed changes to the state budget and tax code, summary

In 1H14, the state reported its budget collections at 8.2% higher than the same year-ago period. The main reason was doubled NBU advance profit wires to the budget (UAH 22 bln in 1H14 vs. UAH 10.1 bln a year ago). At the same time, other collections to the budget (net of NBU support) were reported at only a 1% yoy increase. To make matters worse, state revenue dropped 6.7% yoy in June, when the NBU stopped transferring support.

Against this backdrop, it came as no surprise to see the Cabinet look for alternative ways to fund the budget revenue shortfall. If we assume 2H14 budget revenue to be flat yoy, the full-year revenue will be close to UAH 350 bln, or UAH 23 bln less than the state's current target for the period (the government estimates its revenue shortfall at about UAH 20 bln). In other words, current trends promise the budget deficit will exceed the limit pledged to the IMF of UAH 68.6 bln.

To address the issue, the Cabinet submitted bills for parliament's review on July 31 that would:

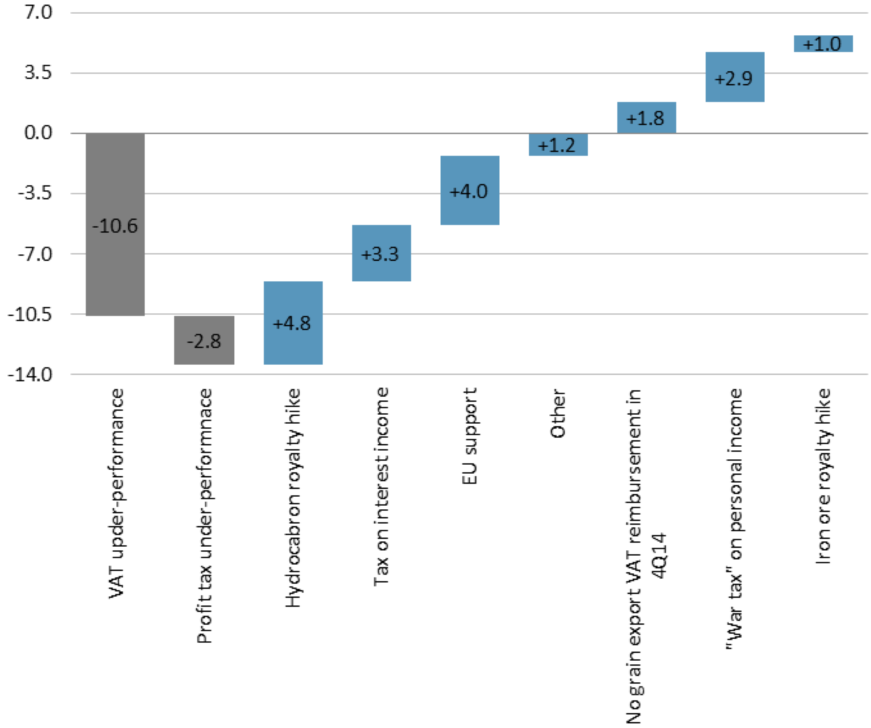
- increase the royalty on oil and gas extraction to gain an extra UAH 4.8 bln by the year end;
- increase the royalty iron ore mining, which might result in an extra UAH 1.0 bln by the year end;
- extend the no-VAT-reimbursement regime for grain exporters till the end of 2014 (currently applied for 2Q14-3Q14) to get an extra UAH 1.9 bln;
- impose a 1.5% "war tax" on personal incomes till the end of 2014 (+UAH 2.9 bln).

Other measures consist of a tax on saving deposit interest, which was imposed a few months ago. The authorities anticipate nearly UAH 4 bln in support from the EU for general budgetary needs. In addition, MinFin proposed various minor amendments like higher excise duties on tobacco, a VAT on the timber-processing industry (VAT-exempt previously) and an additional UAH 1.2 bln in extra revenue from administrative services. With such initiatives, the authorities may boost budget collections by nearly UAH 6 bln, based on our estimate with all the data available thus far.

Considerable changes are being pursued on the side of public spending as well. In particular, MinFin submitted a bill for parliament's review on July 31 that would reallocate substantial funds from economic programs, the pension fund and administrative items to the Reserve Fund (UAH 11 bln). The reallocated funds, as well as boosted tax revenue, will be used to finance the military campaign (UAH 9.1 bln) and to rebuild ruined infrastructure in the Donetsk and Luhansk regions (UAH 1.9 bln).

Importantly, the suggested changes will leave the central budget deficit unchanged at about UAH 69 bln.

**Summary of revised budget revenues, based on the new reality and gov't initiatives, UAH bln**




*Source: Verkhovna Rada, Cabinet of Ministers, Concorde Capital estimates*

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