

## 1.4

# Privatization in Ukraine: Overview and Recent Trends

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### **Introduction**

In 1991, the year of Ukraine's independence, one of the stated priority issues for the country was supposed to be the privatization of state property. During the 10 years that have followed privatization in Ukraine has developed sporadically, in stages, but is presently proceeding rapidly. The privatization process has significantly improved in the course of its development and is now reasonably transparent.

The main objective of this privatization process, as professed in the 1992 Law of Ukraine 'On the Privatization of State Property', the framework legislation on privatization in Ukraine, is to improve the social and economic efficiency of the use of state property and to attract funds for the reconstruction of Ukraine's economy. Privatization is presently an important part of the Ukrainian government's domestic policy as well as one of the major sources of income for the State.

### **History**

The process of privatization of state property may be divided into three types as follows:

- privatization of land and assets in the agricultural industry;
- privatization of housing; and

- privatization of state-owned industrial and other non-agricultural property (excluding housing).

While the agricultural privatization process has been markedly slow in its development the other two types have gone much further and produced better results.

Since the agricultural and housing types of privatization have been mostly reserved for Ukrainian citizens, this chapter will focus on the privatization of industrial and other non-agricultural property (hereafter 'industrial privatization'). This industrial privatization has moved through two stages and is now well into its third stage, as follows:

Initial stage (1992–94). During this period privatization was typically carried out through the leasing and subsequent purchase of the property of state companies by the management and employees of these companies.

Mass privatization stage (1995–97). This stage began in 1995 when all Ukrainian citizens received the right to obtain privatization certificates, a special type of security that could be exchanged for shares of state companies sold in special privatization certificate tenders conducted by the certificate auction centres. Another type of security used in these privatizations was the compensatory certificate issued to cover the losses incurred by the holders of deposits in the State Savings Bank during the period of hyperinflation from 1991 to 1995. Most of these privatization and other certificates were used by the end of 1997, although some tenders using these certificates took place until 2000. Parallel to these certificate privatizations, thousands of small state-owned firms and other state properties were sold through auctions for cash to private owners.

Large-scale cash privatization stage (approx. 1997–present). Unlike the two preceding stages, the main emphasis during this third stage has been to raise substantial revenue for the State. As a rule, during these larger cash privatizations, shares in medium and large companies are privatized by sale for cash in blocks at tenders or as individual shares at stock exchanges. One of the characteristic features of the current privatization process is the sale of shares of strategic and monopolistic companies, for example natural monopolies such as the state telecommunications operator Ukrtelecom (planned for 2002) and the energy distribution companies.

In accordance with data released by the State Property Fund of Ukraine, the state body principally responsible for privatization in Ukraine, over the period from 1992 to 1999 a total of over 50,000 companies were privatized. These companies employ 3.5 million people, or 24.2 per cent of Ukraine's workforce (the total population of Ukraine is currently

approximately 50 million people). The general perception is that the financial state and management of these privatized companies has improved, and in certain branches of industry, such as the food industry, most privatized companies appear to have enjoyed relatively strong economic growth.

At the same time, in the view of many economic commentators, privatization in Ukraine has not achieved most of its declared goals. On the one hand, it has not created a broad class of property owners, as the majority of the shares in the privatized state companies, at least the most valuable ones, were accumulated by a few powerful corporate groups or by the existing senior managers of these companies.

On the other hand, the first two stages of industrial privatization demonstrated that privatization by itself does not automatically guarantee any improvement in the management of the companies or the property involved or result in any genuine restructuring of the economy beyond the change in ownership. All too often, the controlling shares sold by the State were accumulated by a company's existing directors, who continued to apply Soviet-style management techniques. In addition, the non-cash privatizations often also failed to involve adequately financed sources for the funding needed for the modernization of the privatized companies and their future growth.

## **Privatization process**

In Ukraine the privatization process is mainly regulated by the laws of Ukraine and the legal acts of the State Property Fund. The basic laws governing the process are the Laws 'On Privatization of State Property' (the Privatization Law), 'On Privatization Securities' and 'On the Privatization of Small-Sized State Companies' (Small Privatization) adopted in 1992. These laws regulate the overall legal framework governing the privatization process in Ukraine, such as to determine what can be privatized, who can be parties to the privatization process and the privatization procedure to be applied.

The Privatization Law identifies the following three groups of state-owned property that are subject to privatization: (1) shares in the capital of business companies and other entities; (2) unfinished constructions and mothballed developments; and (3) certain individual items of property or 'integrated property complexes' (defined as being a group of assets sufficient to conduct a separate business activity) of state-owned companies. This Law also effectively excludes from privatization state property that is defined as being of 'national importance' (the principal examples of such property are listed in Table 1.4.1). Based on these criteria, a list of particular companies and property that are excluded from privatization is adopted and, from time to time, modified by the Parliament of Ukraine (the *Verhovna Rada*).

**Table 1.4.1** Selected property that cannot be privatized due to its 'national importance'

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- assets of enterprises that ensure the issuance and storage of bank-notes, coins and securities;
  - radio and television transmission centres;
  - state radio and television channels;
  - educational, sport and scientific establishments funded by the State;
  - assets of enterprises producing and repairing arms used by the Ukrainian army;
  - assets of aviation industry enterprises;
  - roads outside a company's premises;
  - railroads and enterprises producing locomotives and rail cars;
  - metros and other electric transport in cities;
  - assets ensuring the operation of the united energy system and the dispatch of electricity as well as the operation of high voltage networks;
  - atomic electro-power stations, combined heat and power plants, hydro-electropower stations using dams that ensure water supply and hydromelioration;
  - oil and gas underground storage facilities and major pipelines;
  - assets of enterprises producing spirits, wine and hard liquor.
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The Privatization Law provides a limited number of restrictions on who can be the purchaser of state property in a privatization. It prohibits from participation in privatizations: (1) legal entities more than 25 per cent owned by the State; (2) state government bodies; and (3) employees of state privatization bodies.

Ukrainian law does not provide for any express restrictions on the participation of foreign persons or entities in privatizations. However, there are a number of statutory limitations on the foreign ownership of, or investment in, the capital of certain entities that may effectively limit foreign involvement in a privatization, as described in Table 1.4.2. In principle, pursuant to the Partnership and Cooperation Agreement between Ukraine and the European Community, the application of many of these limitations to EU-based companies is to be eliminated.

## The state property fund of Ukraine

The main state body responsible for the development and implementation of the state privatization policy is the State Property Fund of

**Table 1.4.2** Foreign investment in Ukrainian companies

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Foreign investment in Ukrainian companies is limited to 30 per cent for the following types of Ukrainian companies:

- publishing houses;
  - organizations distributing publications;
  - information agencies;
  - broadcasting companies and television and radio organizations.
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Ukraine (SPF), established in 1992 by the Ukrainian Parliament pursuant to the Privatization Law and the ‘Temporary Regulation on the State Property Fund of Ukraine’ approved by the Resolution of the Ukrainian Parliament of 7 July 1992, No. 2558 (the Temporary Regulation).

The SPF is proclaimed in Article 7 of the Privatization Law to be an independent state body that is subordinated to, and reports to, the Parliament of Ukraine. However, the Constitutional Court of Ukraine ruled in 1998 that this provision subordinating the SPF to parliament is unconstitutional. The status of the SPF is supposed to be clarified in the proposed law on the SPF, the new draft of which is being considered by Parliament. Currently the debate focuses on whether to subordinate the SPF to the Cabinet of Ministers (the principal state executive body).

The scope of the SPF’s authority is spelled out in Article 7 of the Privatization Law and in the Temporary Regulation. Among other powers, the SPF is given the authority to perform the following functions:

- sell state-owned property in the course of privatization, including the property of liquidated enterprises and uncompleted construction projects;
- take actions to engage foreign investors in the privatization process;
- develop and submit to the Cabinet of Ministers drafts of national privatization programmes, and organize and control their implementation;
- change the organizational and legal form of state-owned enterprises in the course of their privatization by transforming them into open joint stock companies (to facilitate share sales);
- exercise the authority of the owner of the shares of state-owned joint stock companies, which were not sold in the course of a privatization, and bear the commercial risks connected with such shares;
- approve plans for the privatization of state-owned property;
- conclude agreements with intermediaries regarding the organization of the privatization process and the sale of state property;

- act as a lessor of state-owned property;
- participate in the development and conclusion of international agreements on property and the use of state-owned property;
- represent, in Ukraine and abroad, the state's interests in state-owned shares, as well as the interests of state enterprises, organizations and institutions, etc.

The SPF also prepares the triennial privatization programmes that set out the main objectives and terms of privatization for successive three-year periods. The privatization programme is supposed to be reviewed and approved by the Parliament of Ukraine in coordination with the annual state budgets for the relevant period and then remain effective until a new programme is approved.

## Privatization methods and procedure

Privatization methods and procedures differ depending on the entities or other property to be privatized as listed in a privatization programme. In the present privatisation programme for the years 2000 to 2002 (the 2000–02 Programme), the entities or property to be privatized are grouped by type (eg strategic and monopolistic companies, unfinished construction, etc) and the number of persons employed at these state companies.

The privatization programme is implemented by the Cabinet of Ministers and the SPF. They typically begin by creating a privatization commission for each company being privatized, and the commission prepares the actual privatization plan covering all aspects of the privatization process to be applied. Under the Privatization Law, the impetus for a privatization may come from the SPF, or it may be in response to an application from any foreign or domestic prospective buyer (which may include employees of the company to be privatized).

In the past, many privatizations took place through the so-called 'non-commercial' tenders, when the winner was the person who, for the fixed price stated for each such tender, proposed the best investment and operational terms. Presently, the bidders in such tenders also propose the price that they will pay. At these tenders, the winner not only pays for the acquired shares but also undertakes certain investment and other obligations.

Currently, a priority is generally being given to 'commercial' tenders for the larger privatizations, where the winner is determined solely on the basis of written sealed submissions by the potential purchasers quoting a price, with the best price winning. In addition to non-commercial and commercial tenders, which are the two principal methods of

privatization, the Privatization Law also permits auctions, buy-outs and sales through stock exchanges and OTCs (over-the-counter markets) to take place.

The sale of state property in a privatization is documented by a purchase and sale agreement with the SPF, which must be notarized. The agreement ordinarily provides for additional obligations to be imposed on the buyer, usually for defined periods of time, which may include:

- criteria for the reconstruction of the facilities;
- an obligation not to decrease the number of work places;
- preservation of the production of certain products;
- preservation of certain social infrastructure;
- subsequently making investments in certain amounts; and
- performance of ‘mobilization tasks’ (measures designed to restructure the company in case of a threat of war, etc).

Restrictions may exist on any subsequent sale of property acquired in a privatization, if such sale occurs before any such privatization obligations are performed or expire.

According to Article 27 of the Privatization Law, the purchase and sale agreement may be terminated (including by rescission) or declared invalid by a court decision if one of the parties fails to perform its privatization obligations on time. This may be used to reverse a privatization even where the obligation stated in the purchase and sale agreement can only be performed by the company and not directly by the one or more shareholders who bought their shares in the company’s privatization. In such cases, it is essential for the acquiring shareholders to have effective control over the management from the outset.

Ordinarily, purchase and sale agreements concluded in the privatization process provide for payment by the purchaser shortly after the agreement is executed. Article 29 of the Privatization Law contains an important limitation that prevents any extensions of the time for payment and inhibits conditional sales as well. It provides that failure to pay for any privatized property within 60 days from the moment when the purchase and sale agreement was concluded or registered results in annulment of the sale and in fines on the purchaser.

In the recent privatization of six electricity distribution companies this meant that bidders could not make payments into an escrow account and condition their bids on certain due diligence problems being resolved before payment would definitely be released to the SPF. This resulted because resolution of the due diligence problems was expected to take over 60 days and the SPF refused to extend the deadlines for the execution of the purchase and sale agreements.

## **Privatization in 2000 and beyond**

### ***The 2000–02 Programme***

The plan for the present privatization process in Ukraine is outlined in the 2000–02 Programme (referred to above) adopted by the Law of Ukraine of 18 May 2000. In many respects this Programme has marked the advent of a new era in the State's privatization policies compared with the previous privatization programmes. The 2000–02 Programme introduced such measures as privatization being conducted exclusively by cash sales, individualized approaches for each of the companies subject to privatization and greatly increased information transparency of the privatization process. The implementation of these measures is to be facilitated by the involvement of professional advisers to restructure companies before they are offered for sale, and by the employment of competitive mechanism for sales.

The main emphasis of the 2000–02 Programme is the privatization of a number of significant strategic and monopolist companies, including certain 'natural' monopolies like the electricity distribution and telephone companies (the so-called 'Group G' state property), as being the most attractive property to sell in order to raise substantial revenue for the State. The programme introduced a number of special provisions aimed at increasing the efficiency of such sales. A key notion for such procedures is to provide that the so-called 'industrial investors' (companies meeting certain qualifying criteria, including production and management experience) shall be the sole bidders allowed to participate in privatizations in certain areas considered attractive to foreign investors, such as the fuel and energy sector, metallurgy, the petrochemical industry, radioelectronics, airlines and machine building.

The privatization of the Group G companies must be conducted by means of the sale of blocks of shares of these open joint stock companies at commercial tenders. The usual condition for such privatizations is that the sale of the controlling block of shares (being at least 50 per cent plus one) must be to a single buyer. If the controlling block of shares is instead retained by the State, the investor may still be granted the right, at its request, to manage all or part of the state-owned block of shares, depending on the tender's terms.

One of the important preconditions of the sale of shares in monopolist companies is for the bidder to obtain the prior approval for its bid from the Antimonopoly Committee of Ukraine. In certain regulated sectors, such as electricity, bidders must also be approved in advance by the relevant state regulator for their industry.

***Privatization of electricity distribution companies***

Tenders for the sale of six electricity distribution companies were successfully held in April 2001. Despite the uncertainty over the future of the government of Ukrainian Prime Minister Victor Yushchenko at that time, and the insufficient preparation of the companies for privatization (eg lack of clear title to certain key assets, land use rights, required operational approvals and other appropriate documentation), the shares of all six companies were sold to strategic investors, and the prices for two of these companies were significantly higher than predicted. Two companies were purchased by the US company AES Washington Holdings BV and four by the Slovak company Vychodoslovenske energeticke zavody. The State has received approximately US\$160 million in revenue. Based on this experience, the SPF plans to sell the remaining 12 state-owned electricity distribution companies in 2002. Currently the President of Ukraine by his Decree forbids any further privatization of the electricity distribution companies (*oblenergos*) and generating companies until the results of the last sale are analysed. However, this ban is expected to be lifted in the near future.

In the beginning of July 2001, the Ukrainian Parliament (*Verhovna Rada*) adopted a draft law that attempted to suspend the alienation of all state property for a period of time, including all sales of state shares in electricity distribution companies until 1 June 2002. However, the President vetoed this draft law because he objects to the prohibition on the sale of energy companies, and he insisted on exclusion of this provision from the draft. It is unlikely that this veto will be overruled by Parliament.

***Telecommunications – the privatization of Ukrtelecom***

The next major privatization in Ukraine should be of Ukrtelecom, Ukraine's national telecommunications operator. The adoption of the special Law 'On the Peculiarities for the Privatization of the Open JSC Ukrtelecom' of 13 July 2000 (the Ukrtelecom Law) establishes the basis for this sale. The Ukrtelecom Law provides that 50 per cent plus one share of Ukrtelecom shall be retained by the State, while at least 25 per cent plus one share must be sold off to a single qualifying industrial investor in an open tender.

According to Article 17 of the Ukrtelecom Law, 30 per cent of the proceeds received from the privatization must be transferred by the SPF to Ukrtelecom after it is privatized as a subsidy for development of its telecommunications network and for the purchase of modern equipment. The capital fund of the privatized company will accordingly be increased by the issuance of additional shares, which will be added to the remaining state-owned shares and thereby reduce the investor's

percentage shareholding. The net effect of these transactions on the percentage shareholdings in Ukrtelecom is as yet unclear. However, the investor should in any case also have the right effectively to acquire contractually the management of up to half of the shares that are expected to be retained by the State, which should allow the investor to exercise effective control over the company for the term of this management contract.

To qualify as a bidder, the investor must be a telecommunications operator (or a consortium including a telecommunications operator) having at least five years of operational experience, and must satisfy certain documentation requirements. Normally bidders are also required to make a cash deposit of, or provide a bank guarantee for, about 10 per cent of the minimum permitted bid. Bidders may not be registered in 'offshore' jurisdictions. We understand that, as for the privatization of the electricity generators, bids will be placed in a glass box by bidders at the tender, with the bids then being immediately opened to reveal the winner – a literally transparent procedure. The winning bidder will have to enter into a formal purchase and sale agreement for the purchase of the shares, and then pay for them in cash within 30 days after execution of the purchase and sale agreement.

As provided for in the Ukrtelecom Law, the Cabinet of Ministers of Ukraine has already adopted a decision on Ukrtelecom's privatization and has formed a privatization commission for the sale (the Privatization Commission). A privileged sale of about 13 per cent of Ukrtelecom's shares to its present employees (eg the management of the company will have the right to an additional purchase of up to a further 5 per cent of the company's shares) started on 1 October.

The Ukrtelecom Law also expressly requires that the company continues rendering telecommunication services to those persons who are presently benefiting from certain tariff privileges, irrespective of when the State actually pays the planned compensation to the company for the difference in these artificially low tariffs. The conditions of the forthcoming tender and the qualification requirements for investors still need to be determined by the Privatization Commission and approved by the Cabinet of Ministers. An audit by an international accounting firm of Ukrtelecom's accounts for the year preceding the tender will also need to be completed.

The minimum price for bids for the Ukrtelecom shares to be offered has not yet been established. Estimates, based on the assumption that only 25 per cent plus one share will be sold initially, vary from US\$150 million to US\$540 million. In the case of the electricity distribution companies, the minimum price was established at the lower end of the pre-tender estimates, and it is expected by many that the same approach will be applied for Ukrtelecom in order to stimulate interest.

## **Conclusion**

The experience of recent privatizations in Ukraine shows that the Ukrainian authorities are prepared to offer a transparent privatization process for privatization of companies that occupy leading positions in the Ukrainian economy. It also appears that many of these assets will be sold at a substantial discount compared to what would be paid for similar assets in Western, or even Central, Europe.

This is resulting in many unique business opportunities in Ukraine, such as existed 10 years ago in Central Europe when countries such as Czechoslovakia and Poland privatized their state assets. While the proposed privatisation of Ukrtelecom and the remaining Ukrainian electricity distributors and generators have attracted the most attention, in fact a wide variety of businesses are to be privatized in the near future, including the Ukrainian National Airlines, the vehicle producers AutoZaz (passenger cars) and AutoKraz (trucks) and several leading machine building plants.

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