

16th Annual BBSPA Conference
15-16 April 2010
The Marriott Hotel, Vienna

Presentation by Dr. Irina Paliashvili
President and Senior Counsel
RULG - Ukrainian Legal Group, P.A.
Kiev and Washington, D.C.

Ukrainian Upstream Activities and Legislation Framework Updates

I. Latest developments in the legal regime for the onshore and offshore upstream activities

It appears that again in 2009 most of the promises and good intentions declared by the Ukrainian Government (“**GOU**”) to improve the investment climate in the fuel and energy sector have not been implemented. Moreover, several worrisome tendencies of 2008 were further strengthened in 2009:

- Granting special privileges to state-owned companies at the disadvantage of private sector
- Increased confusion and ambiguity in the laws and regulations applicable to the use of subsoil (and specifically to oil and gas sector)
- Continuous legal and practical challenges to the main investment vehicle in the subsoil sector: joint activity agreements (“**JAA**”)
- GOU continues to insist on amendments to the Law “On Production Sharing Agreements” (“**PSA Law**”), which would have a major negative effect for investors.

At the same time, there have been a number of positive developments, especially in the CBM sector, which we include in our overview below.

II. Subsoil Licensing Regime

2009 was marked by the formal restoration of the tender-based licensing regime stipulated in the Subsoil Code and the Law “On Oil and Gas” (“**Standard Legislative Basis**”), which was suppressed every year since 2004 and replaced by the *ad hoc* auction-based system relying not on laws, but on regulations adopted annually by the GOU (the “**Regulation-Based System**”). The Regulation-Based System was quite unstable and unpredictable, leaving the industry at the mercy of the annual GOU Licensing Regulations. The GOU also undertook a practice of adopting the Licensing Regulations as late in a year as possible, leaving the industry paralyzed for several first months of each year.

In the middle of 2008, following the decision of the Constitutional Court, the Law was adopted restoring the Standard Legislative Basis for subsoil licensing. Thus 2009 was supposed to be the first full year since 2003 with the stable tender-based subsoil-licensing regime stipulated in

Subsoil Code and the Law “On Oil and Gas”. That did not materialize in practice because GOU failed to follow the Standard Legislative Basis in its licensing activities.

Instead the GOU continued to rely on its 2009 Licensing Regulations: Licensing Procedure (Cabinet of Ministers Resolution No. 608) and Auction Procedure (Cabinet of Ministers Resolution No. 609), both adopted on 17 June 2009. It should be noted that for the first time the 2009 Licensing Regulations were extended to 2010, so at least there is no gap in subsoil licensing regulation in 2010.

As in previous few years, in 2009 GOU offered very few oil and gas deposits at auctions. At the same time GOU generously granted subsoil licenses to state-owned companies. For example, according to the Cabinet of Ministers Ordinance No. 1095-r of 26 August 2009 subsoil licenses were issued to Naftogaz Ukrayiny (100% state-owned company) without holding an auction with respect to twelve oil-and-gas deposits. Moreover, before granting these licenses, GOU by its Ordinance No. 1094-r of 26 August 2009 had first cancelled the licenses granted with regards to same deposits to other companies in 2007.

Therefore, in 2009 GOU again created preferential opportunities for State-owned companies, offering next to nothing to private sector.

Below we offer a very brief review of negative and positive trends of the 2009 Licensing Regulations, which continue to remain in effect in 2010.

Negative Trends:

- Very short timeframe between announcing of the auction and submission of an application deadline, which in practice would limit the opportunities of companies, especially international ones, to timely submit their applications. Thus, an auction announcement must be published not later than **30 days** before the auction date and only in one Ukrainian central newspaper (“Uriadovy Courier”) and on the Environment Ministry’s website.
- Auction process is burdened with numerous difficult-to-meet (especially for foreign investors) or entirely unfeasible conditions. With the auction to be announced **30 days** before its date, the rules state that the prospective bidders must submit their applications with complete document sets within **15 calendar days** after the date of the announcement, including to pay for and receive auction documents from the Environment Ministry, and to pay an advance fee.
- Auction committee is authorized to cancel an auction without stating its reasons or to withdraw specific licenses without prior notice (even on the day of the auction);
- In 2009 the holders of oil and gas exploration licenses are deprived of an opportunity to receive the production license without an auction, and now must, upon completing exploration, bid for the production license at an auction.
- Model Licensing Agreement contains many conflicting obligations to be assumed by the subsoil user, some of which are contrary to the laws of Ukraine (e.g. those dealing with land allocation), and some of them are not of contractual nature since they are based on mandatory laws and not on mutual agreement of the parties.

Positive Trends:

- The list of cases in which subsoil licenses can be granted without an auction has been reduced substantially from fifteen in 2008 to five in 2009.
- The procedure for issuing subsoil licenses without holding an auction is tightened: a GOU decision is needed in each case (with the exception of underground waters).
- In 2009 the Environment Ministry finally approved Model Licensing Agreement for each type of subsoil (each license must be accompanied by a licensing agreement signed between the subsoil user and the State, which becomes an integral part of the license).
- A single form for the subsoil license was approved in 2009.
- The Environment Ministry cannot unilaterally amend a licensing agreement made with a subsoil user and enclosed to the subsoil license.
- Subsoil license no longer can be cancelled because its holder or the holder's contractor do not have, at the time of initiation of their works, an activity license with respect to such works (exploration or production of mineral resources, etc.).
- The Presidential Edict No. 912 of 10 November 2009 obliges the GOU to ensure equal conditions for receiving subsoil licenses for national and foreign investors.

III. Activity Licenses

In Ukraine a number of activities, related to exploration and production of mineral resources is subject to licensing, i.e. a company in order to engage in these activities first needs to obtain a relevant license ("**Activity Licenses**"). Activity Licenses in the mineral resources sector are issued by the State Geological Service.

A new Law took effect on 19 March 2009, which grants more powers to the State Geological Service: it now issues Activity Licenses not only for exploration of mineral resources, but also for the production of mineral resources from the deposits of national significance.

The following were the positive developments with regards to Activity Licenses:

- GOU Resolution No. 501 dated 21 May 2009 decreased the list of the documents the applicants needs to submit in order to obtain Activity Licenses;
- Unlike in 2008, in 2009 the subsoil license no longer can be cancelled because its holder or the holder's contractor do not possess Activity Licenses.

IV. Joint Activity Agreements (JAA)

Although JAA is the main investment vehicle in the subsoil sector, in 2009 the GOU reconfirmed restrictions imposed earlier on state-controlled (more than 50% stake) companies, which in order to enter into a JAA must obtain a prior approval of the GOU. The GOU continues to fail to establish the procedure for applying and receiving such an approval, making this exercise at best non-transparent or entirely impossible.

Also, given the reinstated Article 14 of the Law "On Oil and Gas" that stipulates express prohibition of **assignment of the rights** stated in subsoil licenses *inter alia* in case of joint activity, the risks involved in JAA have become somewhat higher in 2009. Public authorities interpreted these restrictions as broadly as possible, arguing that the rights to use subsoil, including the rights to dispose of produced hydrocarbons, pay rent and other fees for oil and gas, are not assignable under JAA.

Such interpretation was confirmed by the decree of the Supreme Court of Ukraine published in 2009 (Yurydychny Visnyk Ukrayiny, No. 25, 2009.06, p. 15) by which the Court refused to protect the ownership rights of a non-State party to a JAA to the mineral resources extracted under this JAA arguing that its right to dispose of the extracted hydrocarbons (gas) was restricted by the law.

Therefore, in 2009 the risks involved in the exploration and production of natural resources under JAA have increased for the private sector parties, while the confusing legal regime encourages state-owned parties to default on their obligations under JAA. As was reported in the Ekonomicheskaya Gazeta dated 15 July 2009, "the majority of joint activity agreements are being challenged in courts".

It should also be noted that the GOU is not inclined to change its position on JAA, and in 2009 it submitted to the Parliament a bill that would enforce and broaden restrictions imposed on JAA.

IV. New CBM Law

In a positive and long-awaited development the Law of Ukraine "On Coal Deposits Gas (Methane)" ("**CBM Law**") governing legal relations in the production and use of coal bed methane ("**CBM**") was adopted in 2009. The CBM Law is a timely and important act that will help to promote CBM production and create investment-friendly environment for this sector. It expressly stipulates investment options, including opportunities for making foreign investments in CBM exploration and production under JAA, as well as a simplified procedure for land allocation for CBM projects.

The GOU is undertaking active efforts to implement the CBM Law. A program of priority steps has been developed, which includes *inter alia*:

- drafting other laws that will grant tax exemptions to the entities involved in CBM production;
- development of a legal framework that will enable simplified procedure for auctioning subsoil licenses for CBM extraction from coal deposits.

It appears that CBM Law opens new exciting opportunities in subsoil use, primarily for those investors who have relevant experience and implement modern technologies.

V. Production Sharing Regime

The production sharing agreements (“PSA”) regime has been paralyzed since the GOU challenged in 2008 the PSA it signed in 2007 (following the tender in 2006) with a US-based Vanco International with regards to a large deep-water Prykerchenska block in the Black Sea. While this dispute is currently being considered at the international arbitration under the Rules of Arbitration of the Stockholm Chamber of Commerce, no other blocks were offered by the GOU to investors.

Moreover, GOU continues to lobby a bill on amendments to the PSA Law, which would have a major negative effect for investors. The proposed amendments include *inter alia*:

- limiting blocks offered for PSA to 1000 square kilometers (while the current PSA Law does not limit the size of the blocks);
- limiting Cost Recovery Production to 30% of the output (while the current PSA Law limits cost-recovery production to 70% of the output);
- changing the taxation mechanism and increasing the corporate profit tax applicable to PSA investors;
- stipulating that only legal entities may participate in PSA, thus eliminating opportunity for a consortia of investors;
- requiring at least 80% of local employment (while the current PSA Law envisions that a PSA should set out the investor’s obligation to hire and train Ukrainian nationals, but the precise obligations are left to the parties to negotiate).
- Prohibiting assignment of investor’s stake in the PSA (while the current PSA Law allows the assignment subject to the consent of the State, which cannot be unreasonably withheld).
- reducing the term of a PSA from 50 to 30 years and eliminating the opportunity for an investor to request extension of the PSA term;
- limiting the language of a PSA exclusively to Ukrainian (while the current PSA Law allows bi-lingual Ukrainian-English PSA in case it has foreign parties)

The investment community and industry organizations have expressed their serious concern to the GOU with regards to the proposed amendments. Considering the increasing interest of the investors in the Black Sea and that exploration in the deep waters will require enormous financial and technical resources, which GOU or state-owned companies do not possess, investors expect the GOU to ease its anti-PSA approach.