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## Overview of licensing regime for use of subsoil in Ukraine in 2007



*USUBC NOTE: This very important article from USUBC executive committee member, Dr. Irina Paliashvili, President and Senior Counsel RULG - Ukrainian Legal Group, P.A., reviews the subsoil licensing regime in legislation and in practice in 2007. The full version of the article is found below and in the attachment.*

*As we all know the year 2007, apart from the Vanco success of course, was one of the most depressing years for legitimate foreign investors in the energy sector, and we all hope that the new Government Of Ukraine (GOU) will decisively reverse this trend.*

*However, it is already clear that the problem of regulated gas prices caused in 2007 by the 2007 Budget Law (spelled out in Decree 31) is here to stay.*

*The newly adopted Budget Law has exact same provisions (Article 3), and in order to lift the price control and other restrictions the amendments need to be made to the Budget Law.*

*This and other issues of importance to foreign investors are addressed in the article. The article also describes the loophole in the legislation (section IV), which would allow the current GOU, if they really want it, to quickly attract legitimate foreign investors in the subsoil sector.*

*According to the article, "In 2007 the GOU continued to carry out hostile policies against investors and cultivated an unpredictable, contradictory and arbitrary regime for investment in the energy sector.*

*It remains to be seen whether the new Rada and the new GOU will introduce serious positive changes in the energy sector and the good intentions will be implemented in practice." Morgan Williams*

Ukraine has two alternative regimes for the use of subsoil: the Licensing Regime and the production sharing agreements regime (the "PSA Regime").

The article below is devoted exclusively to the Licensing Regime, including its legislative and practical aspects in 2007 and the prospects for its development in 2008, with special emphasis on its applicability to foreign investors in the oil & gas sector.

There are serious and on-going flaws in the legislative basis for the Licensing Regime, as well as in its practical application. Despite these flaws, the Licensing Regime exists and has been used by domestic and international companies in Ukraine with various degrees of success.

A positive aspect for foreign investors is that Ukraine participates in the Energy Charter and ICSID, as well as bilateral investment protection and tax treaties, which considerably strengthen the protection mechanisms available to them when investing in Ukraine under the Licensing Regime.

### I. LEGAL BASIS FOR THE LICENSING REGIME

The Licensing Regime is regulated by subsoil legislation, which includes: the 1994 Subsoil Code (the "Subsoil Code") and the 2001 Law "On Oil and Gas" (the "Oil & Gas Law") (we omit the laws regulating other types of subsoil resources) and is spelled out in various subsequent regulations.

Therefore a standard laws-based legislative basis, albeit outdated and at times ambiguous and conflicting, does exist for the Licensing Regime (hereinafter - the "Standard Legislative Basis").

Since 2004, however, the Parliament of Ukraine (the "Rada") has suspended the Standard Legislative Basis through annually adopted Laws on the State Budget (the "Budget Laws"), and stipulated an annual ad hoc system for the Licensing Regime based not on laws, but on regulations adopted annually by the Government (the Cabinet of Ministers) of Ukraine (the "GOU").

The 2004 suspension initially seemed to be only a temporary, emergency measure based on just a few lines in the Budget Law, which had no basis in the subsoil legislation. However, over the years, this temporary measure has in practice evolved into a new system of its own.

In sum, the Standard Legislative Basis for the Licensing Regime is being replaced annually by the ad hoc regulation-based system (the "Regulation-Based System").

In practice, this replacement happens through a two-step process: (1) the Standard Legislative Basis is suspended, usually at the end of the year, by the Budget Law for the next year; and then (2) in the first quarter of said next year, usually by mid-March, the GOU adopts licensing regulations for this particular year, which remain in effect only through the end of this particular year (also resulting in the fact that there is no legal basis at all for issuing licenses during the gap period running from 1 January of the year in question until the time when the GOU adopts new regulations, sometimes not until March or even April).

This ad hoc Regulation-Based System, of course, creates a high degree of unpredictability and instability and makes the oil & gas sector much more prone to political influence and dependant on the composition, orientation and discretion of the GOU of the moment.

Unfortunately, for 2008 we do not see the much-needed return to the Standard Legislative Basis as likely because the Budget Law for 2008 again provides for the suspension of the Standard Legislative Basis and renews the flawed Regulation-Based System.

The Licensing Regime is regulatory rather than contractual because under it, an investor applies to the State for a permit (license) to use subsoil ("Subsoil Permit. A Subsoil Permit is issued by a state body authorized to issue Subsoil Permits (the "Licensing Body").

Over the years, the Licensing Body has changed several times, and the current Licensing Body is Ukraine`s Ministry for Protection of the Natural Environment (the "Environmental Protection Ministry").

It should be noted that Subsoil Permits are issued separately for exploration (an "Exploration Subsoil Permit") and for production (a "Production Subsoil Permit").

Issuance of the Subsoil Permit must be accompanied by an agreement between the Licensing Body and the subsoil user on the conditions for using subsoil (a "Licensing Agreement"), which is considered to be an integral part of the relevant Subsoil Permit.

There is no model Licensing Agreement and, in practice, Licensing Agreements vary in their contents, depending on which particular Subsoil Permit they are attached to (for example, the Oil & Gas Law has a list of key terms and conditions for a Licensing Agreement) and many other factors.

Under the Regulation-Based System, Subsoil Permits are generally sold through auctions ("Auction Procedure"). In certain special cases, determined by the GOU, Subsoil Permits are instead granted without holding an auction ("Non-Auction Procedure").

It is important to note that in addition to a Subsoil Permit, which is obtained for the use of a specific subsoil area pursuant to the subsoil legislation, there is also a requirement to obtain a license allowing a company to generally carry out a certain type of activity, such is exploration or production. The licensing of types of activity in various industries is regulated by the Law "On Licensing Certain Types of Economic Activity".

## **II. KEY FEATURES OF THE LICENSING REGIME IN 2007 AND TRENDS FOR 2008**

We have identified the following notable changes to the Regulation-Based System for 2007 as compared to 2006, which we categorize as (1) positive; (2) general; or (3) negative.

### **(1) POSITIVE TENDENCIES**

It appears that in 2007, the following three positive tendencies of high importance to foreign investors were introduced (although there is no guarantee that they will continue in 2008):

- + The respective GOU regulations established clearer (but still not sufficiently clear) provisions with regard to converting an Exploration Subsoil Permit into a Production Subsoil Permit: if certain conditions are met, the holder of an Exploration Subsoil Permit has the right to obtain a Production Subsoil Permit without an auction.
- + This is not an automatic conversion, but it gives the holder of an Exploration Subsoil Permit a strong legal ground in favor of obtaining a Production Subsoil Permit uncontested.
- + The possibility of obtaining a single Exploration-Production Subsoil Permit is more directly implied in the respective GOU regulations.
- + The grounds for reformulating ( transferring) a Subsoil Permit have been expanded and some new possibilities have opened to investors, provided certain conditions are met. These possibilities include reissuing a

Subsoil Permit for the benefit of a new joint venture company ("JV") or for the benefit of a subsidiary or parent company.

+ Under the first possibility, an investor can create a JV with an existing Subsoil Permit holder, and have a Subsoil Permit transferred to the new JV. Under the second possibility, an investor can purchase a 100%- owned subsidiary of a parent company that holds a Subsoil Permit, after the Subsoil Permit has been transferred to the subsidiary (or the other way around).

## (2) GENERAL TENDENCIES

+ The list of the cases when an existing Subsoil Permit can be suspended or cancelled has been significantly revised and expanded (according to information posted on the Environmental Protection Ministry's website, the Ministry cancelled 42 Subsoil Permits in the first quarter of 2007. Half of these were cancelled because the relevant subsoil users had not begun working on the activities for which the Subsoil Permits were issued).

+ Compared to 2006, the list of the grounds for applying for a Subsoil Permit under a Non-Auction Procedure has increased from 10 to 13 and some of the grounds have been restated.

+ The deposit payable at an auction for a Subsoil Permit increased from 5% to 20% of the starting bid for such Subsoil Permit.

+ The auction participation fee in 2007 is no longer refundable to applicants (a 50% refund was stipulated in 2006).

+ The deadline for filing an auction application has been reduced from 30 to 15 days, and the deadline for making the official auction announcement has been reduced from 45 to 30 days, both deadlines counting from the date the auction is held.

We note that these deadlines are unjustifiably tight, and differ significantly from the relevant European standards: the EU Directive 94/22 dated 30 May 1994 "On the Conditions for Granting and Using Authorizations for the Prospects, Exploration and Production of hydrocarbons" established deadlines (for the submission of applications and announcement of auctions) of no less than 90 days in both cases.

## (3) NEGATIVE TENDENCIES

Because projects in the oil & gas sector usually require substantial and long-term investment, the ability of the State to change the rules at any time and at-will has historically worried investors contemplating projects under the Licensing Regime. And in fact, the major problem with the Licensing Regime is its lack of stability, transparency and certainty.

Historically, issuance of Subsoil Permits under the Licensing Regime in Ukraine was very politicized, and this has been especially true in the past several years, and specifically in 2007.

In particular, well-connected companies have received a surprisingly large share of the Subsoil Permits on offer (including in the oil & gas sector). In reality, auctions for Subsoil Permits have often been used as a cover, and only the least attractive and most expensive oil & gas areas were allowed to be auctioned. Subsoil Permits for the rest of the areas have been granted through "exceptions" to the Auction Procedure.

Unsurprisingly, even those few auctions that did take place in 2007 in the oil & gas sector either did not attract any bidders, failed to sell any Subsoil Permits, or sold very few Exploration Subsoil Permits, and no Production Subsoil Permits were offered at all.

The analysis of the Auction Procedure in 2007 shows that it is not sufficiently transparent and allows for baseless cancellation of an auction or withdrawal of some Subsoil Permits from the auction.

In addition to the regulatory flaws, the practical implementation of the Auction Procedure in 2006-2007 was inconsistent, ambiguous, and deeply flawed. This resulted in highly publicized scandals, which caused the President of Ukraine to issue a Decree in the fall of 2007, suspending all future auctions.

In practice, some well-connected local companies often obtain Exploration Subsoil Permits, but rather than investing in exploration, proceed immediately to commercial production (periodically extending the terms of their Exploration Subsoil Permits), using a loophole in the law that allows "test" production in the course of exploration.

Therefore, some holders of Exploration Subsoil Permits are actually not interested in attracting foreign investors or obtaining Production Subsoil Permits because they are already actively involved in "gray" commercial production.

Another negative tendency was that in 2007, the GOU declared unlawful the traditional method by which foreign investors participate in the use of subsoil, to wit, through joint activity agreements with Ukrainian holders of Subsoil

Permits ("JAAs"). In general, JAAs are possible under Ukrainian civil legislation, and in particular the Oil & Gas Law recognizes the tie between JAAs` and oil & gas exploration and production by mentioning it in various contexts.

At the outset, it should be noted that JAAs do not represent a sufficiently solid and risk-free legal basis for long-term investment in the oil & gas sector. First of all, there are a number of legal concerns in the general civil law and the tax regime applicable to JAAs.

Second, JAAs specifically in the oil & gas sector, do not allow foreign investors to acquire any rights to Subsoil Permits held by local partners in the JAAs. The law does not permit a JAA to wholly or partially reformulate (transfer) a Subsoil Permit.

In practice, the Licensing Body usually handwritten on a Subsoil Permit -- previously issued to a JAA`s local partner -- that the deposit was being developed with the assistance of a certain foreign investor on the basis of a JAA.

However, such handwritten notes had no basis in the law, and did not protect foreign investors when conflicts arose with the local partner that held the Subsoil Permit or with State authorities. Because the Subsoil Permit was issued in the local partner`s name only, the foreign investor`s stake in the Subsoil Permit was indirect and based exclusively on its civil-law agreement (JAA) with the local partner.

In practice the Licensing Body (in all its various reincarnations, including the present Environmental Protection Ministry) had always recognized JAAs, and even encouraged foreign investors to invest in oil & gas projects specifically through JAAs.

Another Ministry responsible for the oil & gas sector, the Ministry for Fuel and Energy, seemed to consider JAAs as being almost the only option available to attract foreign investors into the oil-and-gas sector. Meanwhile, the GOU was well aware of this practice and, never raising any objection, silently accepted it.

However, in 2007, the GOU adopted an inconsistent and contradictory approach towards JAAs. The Environmental Protection Ministry continued to recognize and promote JAAs and Mr. Boiko, the Minister for Fuel and Energy, traveled the world and called for international oil & gas companies to invest in Ukraine.

Both knew full well that JAAs are realistically the only option actually being offered to foreign investors. The GOU, however, took a new course in 2007 of undermining their legitimacy in the oil & gas sector.

Following the GOU`s instructions, the State Tax Administration, Ministry of Economy, Ministry of Justice, Ministry of Finance and the same Ministry for Fuel and Energy came to the unanimous -- but unexpected -- conclusion that the GOU considers the use of JAAs to invest in oil and gas exploration and production to be unlawful.

Meanwhile, despite the GOU`s new position, the Ministry for Fuel and Energy`s press service continues to welcome investment in oil & gas sector, declaring in "Uriadovy Courier" newspaper dated 12 June 2007 that Ukraine "is open for such investments" and "can guarantee openness for business, protection of investments based on rules of law and an independent court system and the Government`s political support .".

Obviously the GOU`s inconsistent, hostile and hypocritical position with regard to JAAs creates substantial risks for foreign investment in the oil & gas sector and raises doubts about the GOU`s true intentions.

Finally, another major negative setback in 2007 has been the GOU`s open interference in the gas market. The Budget Law for 2007 and later GOU Resolution No. 31 dated 16 January 2007 introduced restrictions on the sale of natural gas extracted in Ukraine.

Companies in which the State owns a majority stake are now required to sell their natural gas exclusively to NJSC Naftogaz Ukrayiny at a price approved by the National Commission for Regulation of the Electric Power Industry (NCRE), i.e. at low prices set by the State.

It is important to note that these restrictions apply not only to gas owned by companies in which the State owns a majority stake, but also to gas owned by their privately-owned JAA or JV partners.

For example, if a foreign investor happened to have a JAA or JV with such a state-controlled company, the share of extracted gas belonging to this foreign investor would also be subject to these restrictions, and the foreign investor would be forced to sell its share of gas to NJSC Naftohaz Ukrayiny at an artificially low, regulated price.

As a result of the above restrictions, 2007 saw gas prices in Ukraine set not by the free market, but by the State. Predictably, these restrictions outraged the investment community and resulted in litigation - while the GOU openly ignored the protests and court decisions.

Ironically, at the same time the Ministry of Fuel and Energy has opined that, in order to make production profitable, oil and gas companies need to gradually increase the price they charge for natural gas until it becomes profitable

to produce. Most unfortunately, the Budget Law for 2008 contains the same restrictions, so we expect that in 2008, this issue will again wind up in the courts.

#### **IV. SEPARATE PROCEDURE FOR NON-RESIDENTS**

Article 68 of the Subsoil Code stipulates a different procedure for authorizing foreign legal entities and individuals ("Non-Residents") to use subsoil: the Separate Procedure for Non-Residents, which is set forth in more detail in a 1998 GOU Resolution ("Resolution 841") and is tender-based, with the tender's winner subsequently entering into a contract with the GOU.

The Separate Procedure has not been used in practice, but is treated by the GOU as being valid, and therefore can theoretically be applied to non-residents at any time, because it has never been suspended either on the legislative or on the regulatory levels.

Although the idea of reviving the Separate Procedure for Non-Residents may seem far-fetched, if in fact the new GOU has the political will to attract foreign investors, the Separate Procedure could be its best tool for bypassing the restrictions prescribed by laws without needing to first ask the Rada to change the laws.

We believe that the Separate Procedure presents foreign investors with an intriguing opportunity and a sound legal basis for obtaining Subsoil Permits outside of the current flawed Auction or Non-Auction Procedures, and for basing relationships with the GOU on a contract protected by stronger international mechanisms.

#### **V. GOU PLANS FOR THE DEVELOPMENT OF THE**

##### **OIL AND GAS SECTOR**

In 2007 the GOU and the President of Ukraine have made a number of declarations about developing the energy sector, improving its legal basis and attracting foreign investment in this sector, in particular:

(1) The GOU approved a plan to reform and develop the energy sector, which includes:

(a) drafting (in 2007 - 2008) a law "On the Basics of Natural Gas Market Operation" (relevant instructions were given to the Ministry for Fuel and Energy and Naftogaz);

(b) drafting (in 2007 - 2008) regulations on production sharing with the purpose of increasing natural gas production; and

(c) bringing natural gas prices to a level that would cover costs and secure accumulation of capital sufficient to fund further investment in the infrastructure of fuel and energy companies (expected to take place in 2009 - 2012).

(2) In a decision dated 15 June 2007, the Ukrainian National Security and Defense Council ("UNSDC") recommended that the President of Ukraine add the following provisions to the principal guidelines of the State's Policy of Ensuring Ukraine's Energy Security, approved by the Ukrainian President's Edict No. 1863 dated 27 December 2005: "creation of stable, predictable and transparent conditions for investment in the fuel and energy industry by improving the legislation without prejudice to international standards".

Also, according to the UNSDC decision, the GOU was instructed to approve and implement, by the end of 2007, measures to improve the procedure for attracting investment in the exploration and production of Ukrainian hydrocarbons, in particular hard-to-extract and depleted reserves.

(3) By his Decree No. 842 dated 7 September 2007 the President of Ukraine approved a plan for stabilizing the natural gas market and instructed the GOU to draft a law whereby investors would be involved in oil and gas projects through tenders.

Unfortunately, to date, these good intentions have not been implemented. In practice, in 2007 the GOU continued to carry out hostile policies against investors and cultivated an unpredictable, contradictory and arbitrary regime for investment in the energy sector.

It remains to be seen whether the new Rada and the new GOU will introduce serious positive changes in the energy sector and the good intentions will be implemented in practice.

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