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Oil, Gas & Energy Law Intelligence

Overview of Ukraine's Legal Regime for Upstream Oil & Gas Sector in 2010 and the Beginning of 2011

by I. Paliashvili and T. Lukanina

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Overview of Ukraine's Legal Regime for Upstream Oil & Gas Sector in 2010 and the Beginning of 2011

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We have been reporting on an annual basis on the new developments in Ukraine's upstream oil & gas sector for many years, and 2010 was an especially significant year because of the changes in Ukrainian Government ("GOU") and the new direction it took at opening the natural resources sector for investment. There have been a number of important developments, most notably the sharply increased interest in investment opportunities in Shale Gas and the Black Sea Shelf, the new taxation regime stipulated by the recently enacted Tax Code and the changes (mostly positive) in the legal regime for production sharing agreements ("PSA").

Although 2010 was a very active year for the natural resources sector, GOU so far has failed to transform its good intentions into practice and has not demonstrated sufficient political will to offer real opportunities. The main obstacles to the investment in this sector remain:

- confusing, conflicting, unstable and archaic legal environment;
- indifferent and at times hostile attitude of local bureaucracy, especially at mid-levels;
- government interference in the natural resources markets, including controlling gas prices;
- GOU favoring State-owned companies at the expense of private-sector companies;
- lack of transparency and clarity in GOU's actions.

Nevertheless, for the first time in several years, the prevailing mood in the investment community is modest optimism and anticipation, which is further encouraged by positive signals coming from GOU:

- meetings of the GOU leadership in February 2011 with top executives of major IOCs (President Yanukovich – with Shell, Prime Minister Azarov – with Chevron, and upcoming meetings of Minister of Energy and Coal Industry Boyko with IOCs in the United States);
- the Interagency PSA Commission recommending several Shale Gas areas to be included in the list of subsoil areas eligible for PSA;
- the completion of negotiations and soon expected peaceful settlement between GOU on the Vanco PSA dispute (in particular Vice Prime Minister

Klyuyev recently announced that the settlement will be signed with Vanco Prykerchenska Ltd as soon as sometime in February 2011).

This article consists of the following sections:

I. Subsoil Licensing Regime

II. Cancellation of Activity Licenses

III. Joint Activity Agreements (JAA)

IV. Production Sharing Agreements (“PSA”) Regime

- (A) PSA Amendments Law
- (B) Law on Public Private Partnership
- (C) Pending Settlement of the Vanco Dispute
- (D) Practical Opportunities for PSAs

V. Shale Gas

VI. Other Developments in the Natural Resources Sector

- (A) New Legislative Acts adopted in 2010
- (B) The GOU Actions Aimed at Attraction of Investors into Natural Resources Sector
- (C) The Parliament Hearings on State's Monopoly on Hydrocarbons Extraction

I. Subsoil Licensing Regime

The GOU specifically addressed the problems in the Subsoil Licensing Regime in the Program of Economic Reforms for 2010-2014¹ which outlined the required measures and stages for reforming specifically oil & gas sector:

- harmonizing and improving licensing and other regulatory procedures for exploration and production of hydrocarbons;
- establishing equal rules for national and foreign investors in this sector.

Not much progress has been achieved so far. As in previous years, the procedures for granting Subsoil Licenses (special permits) and holding subsoil auctions in practice continued to be regulated not by laws, but by temporary GOU resolutions (“**Licensing Regulations**”), which are adopted on an annual basis. It is interesting to note, however, that GOU adopted a decision, which took effect on 1 January 2011, abolishing the practice of temporary annual Licensing Regulations and requiring that starting from 2011 they must be adopted on a permanent basis. So far no such permanent Licensing Regulations were adopted.

¹ Cabinet of Ministers of Ukraine (“CMU”) Ordinance No. 892 dated 14 April 2010.

In contrast to the previous years, however, 2010 was the first year when the Licensing Regulations were changed mid-year: **in the first half of 2010** the Licensing Regulations in effect were the two Cabinet of Ministers Resolutions adopted on 17 June 2009 and extended for 2010; **in the second half of 2010** the above Resolutions were replaced by Resolutions "On Approving the Procedure for Granting Special Permits to Use Subsoil in 2010" No. 596 dated 23 June 2010 and "On Approving the Procedure for Holding Auctions for Sale of Special Permits to Use Subsoil in 2010" No. 662 dated 21 July 2010. This development most likely can be explained by the 2010 change of GOU, with new GOU refusing to be bound by the regulations adopted by its predecessor in such an important sector.

Analysis of the Licensing Regulations applicable in the second half of 2010 shows the following negative and positive trends.

Negative Trends:

- The list of cases when Subsoil Licenses may be granted without an auction or tender (i.e. on a non-compete and non-transparent basis) was expanded from five to fourteen.
- A possibility was introduced of granting Subsoil Licenses based solely on a GOU decision without stipulating any specific requirements or grounds (again on a non-compete and non-transparent basis).
- The procedure of negotiation and adoption of decisions by the Ministry of Ecology and Natural Resources ("**Ecology Ministry**") on granting Subsoil Licenses without an auction or tender was made more complex. Thus, there are two different interdepartmental agencies (interdepartmental subsoil use **commission** and interdepartmental subsoil use **working group**), both of which are empowered to make decisions on granting Subsoil Licenses depending on specific grounds from among the grounds stipulated by the Licensing Regulations. The composition of those agencies was renewed in 2010.
- Although the Licensing Regulations (and until the end of 2010 the Law "On Oil and Gas") provided for the possibility to grant Subsoil Licenses at *tenders* for use of strategic minerals (instead of *auctions*), no clear procedure was established for holding such tenders and as a consequence no such tenders were held at all. Moreover, it should be noted that at the end of 2010 amendments were adopted to Article 14 of the Law "On Oil and Gas" eliminating the tenders altogether and leaving the auctions as the only competitive mechanism for obtaining Subsoil Licenses in oil & gas sector.
- the Ecology Ministry received the right to unilaterally amend Licensing Agreements made with a subsoil user, which are an

integral part of the Subsoil Licenses (while the previous Licensing Regulations expressly prohibited such unilateral amending).

- The fee for extension of an Exploration Subsoil License was considerably increased from 1% to 5% of the initial price it was sold at the auction, and the fee for extension of a Production Subsoil License was raised to 20% (in contrast to 10% in 2009).

Positive Trends:

- While the previous Licensing Regulations deprived the holders of Exploration Subsoil License from an opportunity to convert them into Production Subsoil License, the current Licensing Regulations allow a holder of Exploration Subsoil License, which conducted geological exploration and calculated and approved the reserves according to the established procedure, to obtain Production Subsoil License without the need to compete for it at an auction.
- The list of cases when a Subsoil License may be reformulated (transferred) was expanded, although it still remains extremely limited.
- Models were adopted for Licensing Agreements, which must accompany every Subsoil License and are an integral part thereof, which makes such Licensing Agreements more transparent. There are different models for different types of subsoil use (exploration, exploration with test production and production)

In practice in 2010, as in 2009, the GOU offered negligible number of Subsoil License for hydrocarbons at auctions and only four auctions were held. At the same time, the GOU continued to grant Subsoil Licenses on a preferential basis to State-controlled companies without an auction (or tender) and continued to adopt decisions to this effect. The lack of transparency became even more evident because some of these decisions were not even published.

For example, the Cabinet of Ministers Ordinance No. 316 "On Granting Special Permits to Use Subsoil" dated 2 March 2010 was never published and only became known because of a court dispute that followed. According to the court materials, the claim was filed by JSC "Producing Company" Ukrneftebureniye" challenging a provision of the above Ordinance, which obliged the Ecology Ministry to grant a Subsoil License for Sakhalinskiy oil and gas condensate deposit (Kharkiv region) to the State-owned company NJSC "Naftogaz Ukrayiny" ("**Naftogaz**"). The court ruled the above Ordinance illegal and invalidated it. The Cabinet of Ministers together with Naftogaz appealed, but on 1 December 2010 the court of appeal upheld the ruling. A positive aspect of this story is that the court precedent was

established protecting the right to obtain a Subsoil License against illegal actions of the GOU.

Another example, when the GOU decision was published, but still is perplexing on many levels, is the Cabinet of Ministers Ordinance No. 2295 adopted on 22 December 2010 granting a coal mine (Zasiad'ko Coalmine in Donetsk region) the right to obtain combined Exploration & Production Licenses for 9 oil and gas deposits for a term of 20 years. First, the Licenses were granted on a non-compete basis (without an auction or tender). Second, the Licenses were granted not to an oil & gas company, but to a coal mine. Third, GOU very rarely grants 20-year combined Exploration & Production Licenses, but in this case such Licenses were granted, and for quite a large number of deposits too.

II. Cancellation of Activity Licenses

In Ukraine a number of activities, related to exploration and production of mineral resources were subject to licensing, i.e. a company in order to engage in these activities in general first needed to obtain a relevant license (“**Activity Licenses**”). A separate Activity License was required for exploration and for production (extraction of minerals) activities. These Activity Licenses were issued by the State Geological Service. Effective 17 October 2010 such types of economic activity as exploration and production of minerals are no longer subject to licensing².

This means that at present the exploration and production works may be carried out by any company without the need to obtain Activity Licenses. Such company may be itself the holder of a Subsoil License or may be subcontracted by another company that holds a Subsoil License, but neither needs Activity Licenses any longer.

III. Joint Activity Agreements (JAA)

In 2010, as in previous years, there were the same restrictions and risks in place for entering into joint activity agreements (**JAA**) with state-controlled (more than 50% stake) companies, which, since May 2008, in order to enter into a JAA must obtain a prior approval of the GOU. Because the procedure for obtaining such an approval does not exist, it makes this exercise at best non-transparent or entirely impossible. One known example of GOU's approval is the Cabinet of Ministers Ordinance dated 10 December 2010 (and only published more than a month later) approving a JAA between State-owned joint stock company Chornomornaftogaz (a subsidiary of Naftogaz) and Lukoil with regards to three subsoil areas on the Black Sea shelf: Odesskoe, Bezimennoye and Subbotinskoye. The share of Chornomornaftogaz in this JAA must be no less than 50% and the JAA, after it is signed, must be submitted to the GOU for the final approval.

² Law No. 2608 dated 19 October 2010.

In general the JAAs, which have been the main investment vehicle in the subsoil sector for years, remain under attack by GOU. In particular, the tax authorities keep insisting on their long-standing position that the **rights of ownership** to the extracted minerals may belong only to the subsoil user that obtained the special permit to use subsoil, and such rights cannot be contributed (assigned) under the JAA³.

Moreover, in December 2010 a new version of Article 14 of the Law "On Oil and Gas" was adopted⁴ (taking effect on 1 January 2011) confirming that contributing the rights arising out of Subsoil Licenses into a JAA is prohibited.

At the same time, in contradiction to the above position, another new law adopted in 2010, the Law "On the Fundamentals of the Natural Gas Market Functioning", expressly stated that companies, irrespective of the form of ownership, which own natural gas by virtue of the right of ownership, *including the right arising out of JAAs*, may be considered owners of such gas⁵.

The confusing and inconsistent attitude of GOU towards JAAs remains a serious risk factor for using them as investment mechanism in oil & gas sector.

IV. Production Sharing Agreements ("PSA") Regime

2010 saw many significant, mostly positive, developments in the PSA regime, which is an alternative to Subsoil Licensing regime.

(A) PSA Amendments Law

Over the years there were several attempts to amend the existing investor-friendly PSA Law. Some of these amendments, especially those pursued by GOU in 2009, would have made any PSA-based investment prohibitive, and were furiously opposed by the investment community. Fortunately these GOU amendments were abandoned, and in 2010 an older set of amendments introduced by a Parliament Deputy a few years ago and adopted as a Law, but not signed by the President at that time, was revived, improved and adopted as a new Law ("**PSA Amendments Law**")⁶. In a dramatic development the PSA Amendments Law was vetoed by the President and then re-adopted taking into account all proposals by the President.

In general the PSA Amendments Law will have a very positive effect with one important caveat: one of the Presidential veto's provisions cancelled the stability clause (guarantees against changes in the legislation for the duration of the PSA) contained in Article 27 of the original PSA Law, which the investors consider essential for such long-term and high-cost investment. Although there are similar stability clauses in other Laws currently in effect (for example, in the Law "On Investment Activities"), which broadly cover the

³ State Tax Administration Order No. 185 dated 25 March 2010.

⁴ Law No. 2856 dated 23 December 2010.

⁵ Law No. 2467 dated 8 July 2010.

⁶ Law No. 2562 dated 23 September 2010.

PSAs, the GOU was strongly criticized for this move because it altered the PSA regime to the extent that it may become unattractive and too risky to international investors. Many investors declared both publicly and privately that no investments should be expected under the PSA regime unless the GOU restores the stability clause. The GOU swiftly made amends by introducing a strong stability clause with regards to the PSAs taxation regime in the recently adopted Tax Code and supporting the re-introduction (by a Parliament Deputy) of the general stability clause into the PSA Law, which is currently pending at the Parliament.

The following provisions of the PSA Amendments Law should be specifically mentioned:

- (1) The priority of PSA Law over other Laws in the sphere of PSA regime is reinforced.
- (2) The provision on the parties to the PSA was reformulated stipulating that the State shall be represented in a PSA (solely) by the Cabinet of Ministers of Ukraine, and effectively removing local authorities as another counterparty representing the State vis-à-vis the investor.
- (3) The procedure for granting a *land plot* for PSA purposes (along with granting of a *subsoil area*) was provided.
- (4) For the first time a possibility for converting presumably any Subsoil License into a PSA without a tender (based on a decision of the Cabinet of Ministers) was provided. This provision potentially may have a revolutionary effect if the existing Subsoil License holders massively apply for converting their Subsoil Licenses into PSAs; but so far this provision remains only theoretical, and no implementation regulations or procedures have been adopted yet. It remains to be seen how (if ever) this provision will be implemented in practice.
- (5) The procedure for extending a PSA was simplified;
- (6) The list of cases for early termination, or restriction, or suspension of the right to use subsoil under a PSA was considerably shortened.
- (7) The State undertook an obligation to indexate the costs to be reimbursed to the investor by means of cost-recovery production, in case such costs were not timely reimbursed.
- (8) Taxation conditions stipulated for PSA purposes were improved.
- (9) A number of other Laws (primarily the Subsoil Code) were improved and harmonized with the PSA Law, creating a more clear and transparent legal framework for PSAs, including in the

exclusive (maritime) economic zone and the Continental Shelf of Ukraine:

- some of the authorization procedures in the sphere of subsoil use based on PSAs have been simplified and clarified (for instance, it was established that a PSA shall be a basis for issuance of Subsoil Licenses and the rights to use subsoil occur on the day of signing of the PSA);
- selected legal loopholes of the customs legislation applicable to the hydrocarbons extracted in the custom territory outside of the State border of Ukraine, but within its exclusive (maritime) economic zone, were eliminated;
- some conflicts in the law that negatively affected PSA regime were eliminated (for example, granting of authorization documents within the Continental Shelf and exclusive (maritime) economic zone were regulated).

(B) Law on Public Private Partnership

In 2010 the Law "On the Public Private Partnership" ("**PPP Law**")⁷ was adopted. Although the PPP Law is of declarative nature, it does apply, *inter alia*, to PSAs, which caused additional contradictions and risks to the PSA legal framework. An amendment separating the PP Law and the PSA Law was introduced and is currently pending at the Parliament.

(C) Pending Settlement of the Vanco Dispute

The PSA regime in practice 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 (later assigned to Vanco Prykerchenska Ltd, which has a mixed ownership) with regards to a large deep-water Prykerchenska block in the Black Sea. The dispute was referred to the Arbitration of the Stockholm Chamber of Commerce. In 2010 the GOU made a widely praised move towards the amicable settlement of this dispute, avoiding huge potential reputational and material costs. It is expected that the dispute will be settled in the near future, reassuring investors to seek new opportunities under the PSA regime. In particular Vice Prime Minister Klyuyev announced that the settlement will be signed as soon as sometime in February 2011.

(D) Practical Opportunities for PSAs

Although no PSA tenders have been announced in 2010, the GOU entertained several initiatives by investors requesting PSA tenders for various subsoil areas, and even placed some of these areas on the List of PSA-eligible deposits, with a number of other areas currently being considered.

⁷ Law No. 2404-VI dated 1 July 2010.

Although PSA regime may be applied to any subsoil areas on-shore and off-shore, in practice it is understood that the PSA mechanism will be offered mostly for Black Sea Continental Shelf (both shallow- and deep-waters) and for some Shale Gas areas. There have been many encouraging signs that finally 2011 may become a pivotal year for real PSA investment opportunities.

V. Shale Gas

Shale Gas became a focus of attention in Ukraine's upstream sector and many IOCs are looking into these opportunities or even announcing their shale gas plans. The GOU initially was caught unprepared for this active interest and is eager to learn from the experience of other countries, most notably the US and Poland.

So far there is no proper legislative framework for exploration and production of Shale Gas in Ukraine, Shale Gas even appears to be outside of the scope of legislative regulation applicable to such traditional fuels as oil and natural gas (such as the Law "On Oil and Gas" and other laws and regulations). Therefore, it is not clear at the moment how Subsoil Licenses for exploration and production of Shale Gas can be obtained.

The only reliable alternative, which would sidestep the legal ambiguities related to Shale Gas, is PSA regime, but so far the GOU has not offered any Shale Gas opportunities under either Licensing Regime or PSA regime. A very important first step was made by GOU at the end of January 2011 towards preparing PSA tenders for two Shale Gas areas: the GOU's Interagency PSA Commission, responding to the initiative of two IOCs, recommended for the inclusion on the PSA List the Oleska and the Yuzivska Shale Gas areas. The inclusion of these areas in the PSA List will be finalized when the Cabinet of Ministers approves the amendments to its Resolution containing the PSA List, which is a necessary pre-requisite for preparing respective PSA tenders for these areas.

VI. Other Developments in the Natural Resources Sector

(A) New Legislative Acts adopted in 2010

(1) The long-awaited ***Law "On the Fundamentals of the Natural Gas Market Functioning"***⁸ considerably liberalized the natural gas market, providing for:

- free choice of natural gas suppliers and the terms and conditions for such supply;
- liberalized conditions for trade in natural gas, in particular at auctions, exchanges and through tenders;

⁸ Law No. 2467 dated 8 July 2010.

- specified types of activity in the natural gas market subject to licensing (transportation by major pipeline, distribution of natural gas and associated gas, supplies as per regulated and unregulated tariffs, storage of natural gas);
- access to the single gas transmission system of Ukraine based on the principles of equality of rights of all natural gas market participants;
- functions of authorized State agencies concerning regulation and control in the sphere of the natural gas market.

The above Law will be enacted by stages starting from 1 January 2012 (first stage) and from 1 January 2015 (second stage).

(2) Adoption of the Law "On the Fundamentals of the Natural Gas Market Functioning" facilitated ***Ukraine's accession to the Treaty establishing the Energy Community*** (Energy Community Treaty of 2005, Athens). In December 2010 the Parliament adopted the Law on Ratification of the relevant Protocol on Ukraine's accession to the Energy Community (EC). Ukraine, in the beginning of 2011, has notified the Secretary General of the Council of the European Union as the Depository for the Treaty, thus completing the accession procedures and becoming the tenth Party to the Energy Community.

(3) **Tax Code** was adopted on 2 December 2010⁹ and took effect on 1 January 2011, establishing the following important provisions for the natural resources sector:

- conditions for payment and amounts of the rent for transportation of oil and transit of gas and ammonia through the Ukrainian territory;
- conditions for payment and rates of the rent for oil and natural gas and gas condensate produced in Ukraine, increasing the rent for production of oil, gas and gas condensate by approximately 40%. According to Article 258, the rate of the rent for oil and gas condensate extracted from a depth of up to five thousand meters was increased from 1529,9 UAH per ton to 2141,86 UAH per ton; and from deeper depths –from 566,1 UAH per ton to 792,54 UAH per ton. The rate of the rent for natural gas including oil (associated) gas extracted from a depth of up to five thousand meters increased from 200 UAH per a thousand cubic meter to 280 UAH per a thousand cubic meters; from a depth of over five thousand meters – from 100 UAH per

⁹ Law No. 2755 dated 2 December 2010.

a thousand cubic meters to 140 UAH per a thousand cubic meters.

- conditions for payment and rates of fees for subsoil use;
- special (and preferential) tax regimes including for PSAs.

(B) The GOU Actions Aimed at Attraction of Investors into Natural Resources Sector

- (1) In October 2010, the Cabinet of Ministers¹⁰ approved the draft memorandum of cooperation between the Cabinet of Ministers, Naftogaz and the Russian Federation government and "TNK-BP" group of companies concerning exploration and production of gas in Donetsk region. According to unofficial publications, TNK-BP is interested in six subsoil areas in Donetsk Region and may invest \$ 50 million in exploration of those areas during the upcoming three years. It is also reported that the above memorandum was signed on 27 October 2010 and that TNK-BP has already set up LLC "TNK-BP Exploration and Production of Ukraine" (*TNK-BP Rozvidka ta Vydobutok Ukrayiny*) for production of gas from unconventional sources in Ukraine.
- (2) The GOU initiated an investment project titled "Supplies of Liquefied Natural Gas to Ukraine and Construction of the Regasification Terminal"¹¹.
- (3) With the aim of attracting investments into development of hydrocarbon deposits in the Black and Azov Sea Shelf the Ministry of Fuel and Energy and Naftogaz developed in 2010 a "Concept of Development of Hydrocarbon Resources of the Ukrainian Economic Zone of the Black Sea and the Sea of Azov Until 2019", which is currently being considered by GOU.

(C) The Parliament Hearings on State's Monopoly on Hydrocarbons Extraction

On 1 July 2010, the Verkhovna Rada of Ukraine adopted Resolution No. 2386 to hold parliament hearings on the subject of "**Condition and Prospects for Hydrocarbons Extraction in Ukraine and Introduction of the State's Monopoly on this Activity**", and the actual Hearings were held on 12 January 2011.

The idea of introducing the State's monopoly on extraction of hydrocarbons in Ukraine was proposed by the Communist faction in the Parliament and was shocking to the investment community and quite contrary to what the new

¹⁰ CMU Ordinance No. 2126 dated 25 October 2010.

¹¹ CMU Ordinance No. 992-r dated 31 March 2010.

GOU has been declaring since it came into power in early 2010. Fortunately at the actual Hearings this idea was outright rejected by most of the participants, including by the GOU representatives, and the Hearings instead turned into a healthy debate on how to improve the oil & gas sector and make it more attractive for investment.

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RULG-Ukrainian Legal Group is a full-service law firm based in Kiev and Washington, D.C. that provides comprehensive legal support to international corporate clients doing business in Ukraine and other CIS countries. One of the RULG's key practice areas is upstream oil & gas, both under licensing regime and under the PSA regime. RULG authored the production sharing legislation (two laws and a number of regulations) for Ukraine, which provided the legislative basis for the first ever Ukrainian PSA signed in October 2007. Detailed information about RULG practice is available at www.rulg.com. Dr. Paliashvili can be contacted at irinap@rulg.com