

RUSSIAN PETROLEUM INVESTOR

Political and business intelligence
for energy investors in the FSU



Russia
The Caspian
Central Asia
The Baltics



THOMSON REUTERS

January 2010
Volume XIX Issue 1

In This Issue:

**The Search Continues
for an Oil Product
Pricing Formula**

**Plans and Forecasts
Revised for 2010-2012**

**Update on Licensing for
Ukrainian Subsoil Use
and Trends for 2010**

**Analysis: Russia
Embraces New Global
Natural Gas Organization**

**Gazprom Neft Moves on
the M&A Market**

An advisory service of

WorldTrade Executive, a part of Thomson Reuters

Table of Contents

Government

11 Plans and Forecasts Revised for 2010-2012

By Inna Gaiduk

According to the Ministry for Economic Development forecast, updated in December for the period of 2010-2012, annual crude oil production will total 493-494 million tons (an increase of 3-4 million tons over the previous forecast approved by the government in September), while natural gas production will amount to 643-669 billion cubic meters (the previous forecast put it at 623-649 billion). In addition, projected exports of crude, gas and oil products have also grown due to higher than expected prices for oil and a faster economic recovery than anticipated. At the end of 2009, Gazprom and the largest oil companies also corrected plans and forecasts for 2010. The oil companies expect growth of oil production on average from 1 to 5 percent. Gazprom plans to increase gas production from 8 to 18 percent.

18 Update on Licensing for Ukrainian Subsoil Use and Trends for 2010

By Dr. Irina Paliashvili, President and Senior Counsel, and Tamara Lukanina, Senior Counsel, RULG - Ukrainian Legal Group, P.A., Kiev and Washington

We have been reporting in *Russian Petroleum Investor* on the new developments in the subsoil licensing regime for several years and it appears that again in 2009 most of the promises and good intentions declared by the Ukrainian government to improve the investment climate in the fuel and energy sector have not been implemented.

Corporations

22 2009 in Review

By Sergei Glazkov

In 2009, Russian oil companies recovered losses from the crisis. They have increased production, returned to the previous year's profitability and have conducted multi-billion merger and acquisition

Government

5 The Search Continues for an Oil Product Pricing Formula

By Ilya Kedrov

On December 9, the first session of the Russian Federal Antimonopoly Service (FAS) advisory council on the crude oil and oil products markets took place. It confirmed that the fair price indicator of oil products in Russia should become commodity exchanges. Prior to that decision, the council had discussed formation of the formula for domestic oil products prices with the management of the largest Russian oil companies. The FAS and the companies have practically the same positions concerning gasoline prices: the price on the Russian market until occurrence of full scale commodity exchange listing quotations will be determined based on quotations of the global market minus Russian duties and taxes. After introduction of the second antimonopoly package, the companies find themselves in a difficult position. They have no concrete rules for pricing oil products in attempting to follow the law.

transactions. At the end of 2009, Prime Minister Vladimir Putin commissioned the first stage of the East Siberia-Pacific Ocean oil export pipeline and initiated shipment of the first oil tanker from Kozmino on the Pacific coast. The second tender round for development rights at Iraqi oil and gas deposits finally brought success for consortia having Russian participation -- LUKOIL at West Qurna-2 and Gazprom Neft at Badra. Russia has energetically advanced the Nord Stream and South Stream pipeline projects. Russia and Germany have provided the permissions to construct Nord Stream, while Gazprom is considering an opportunity to construct a South Stream branch to Croatia through Serbia or Slovenia. Finally, Russia and Turkmenistan have agreed to renew deliveries of Turkmen gas.

30 Salym Petroleum Development: "The Best of Russia with the Best of the West"

By Elena Kirillova

At the end of 2009, Salym Petroleum Development (SPD) won the 2009 International Petroleum Technology Conference (IPTC) "Excellence in Project Integration" award. In 2009, the company also experienced essential corporate changes. Sibir Energy, one of its owners,

had its controlling shareholder change to Gazprom Neft (a virtually 100 percent subsidiary of Gazprom). As a result, two global giants -- Royal Dutch/Shell and Gazprom -- begin to implement a second joint project, alongside Sakhalin Energy. In addition, previous managing director of Shell China E&P, Simon Durkin has become new CEO of SPD. *Russian Petroleum Investor* questioned Durkin how it was possible for the company to achieve such successful results during the financial crisis, applying the company's approach - "the best of Russia with the best of the West" -- combining Shell's advanced technologies with Russian experience working in the harsh and remote environment of Western Siberia.

Natural Gas

34 Analysis: Russia Embraces New Global Natural Gas Organization

By Kent F. Moors, Ph.D.
Contributing Editor

A December 2008 Moscow meeting for the first time provided the Gas Exporting Countries Forum (GECF) with a charter and structure. Now in Doha a year later, the organization seems finally ready to have a greater impact on international natural gas pricing. For Russian gas leader Gazprom, the forum may prove more necessary than first supposed.

Update on Licensing for Ukrainian Subsoil Use and Trends for 2010

By Dr. Irina Paliashvili, President and Senior Counsel, and Tamara Lukanina, Senior Counsel, RULG - Ukrainian Legal Group, P.A., Kiev and Washington

We have been reporting in Russian Petroleum Investor on the new developments in the subsoil licensing regime for several years and it appears that again in 2009 most of the promises and good intentions declared by the Ukrainian government to improve the investment climate in the fuel and energy sector have not been implemented.

Various progressive policy guidelines, in particular, stated in the "Ukrainian Breakthrough For the People, Not For Politicians" Action Program by the Government of Ukraine (GOU) and in various decisions of Ukraine's National Security and Defense Council (that called on June 5, 2009 "to remove administrative obstaclesthat hinder investors' involvement in the.....exploration and production of hydrocarbons") largely have been ignored.

The declared goals of establishing a clear, stable and transparent legal framework and investor-friendly regime in the oil and gas sector have not been achieved. Moreover, several worrisome tendencies of 2008 were further strengthened in 2009:

- Granting special privileges to state-owned companies to the disadvantage of the private sector
- Increased confusion and ambiguity in the laws and regulations

applicable to the use of subsoil (specifically in the oil and gas sector)

- Continuous legal and practical challenges to the main investment vehicle in the subsoil sector: the joint activity agreement (JAA)
- GOU continued insistence 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 coal bed methane (CBM) sector, which we include in our overview below.

Subsoil Licensing Regime in 2009

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" (the Standard Legislative Basis), which was suppressed every year since 2004 and replaced by an 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 of the first months in each year.

In the middle of 2008, following the decision of the Constitutional

Court, a 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 the 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 June 17, 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 the past several years, the GOU in 2009 offered very few oil and gas deposits at auction. At the same time, it generously granted subsoil licenses to state-owned companies. For example, according to the Cabinet of Ministers Ordinance No. 1095-r of August 26, 2009, subsoil licenses were issued on 12 oil and gas deposits to Naftogaz Ukraine (a 100 percent state-owned company) without holding an auction. Moreover, before granting these licenses, the GOU by its Ordinance No. 1094-r of August 26, 2009 had first cancelled the licenses granted in 2007 to other companies for the same deposits.

Therefore, in 2009 the GOU again created preferential opportunities for

state-owned companies, offering next to nothing to the 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:

- A very short timeframe between announcing an auction and submission of an application deadline, which in practice would limit the opportunities of companies, especially international, to submit their applications in a timely fashion. 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.
- The 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, which includes paying for and receiving auction documents from the Environment Ministry and paying an advance fee.
- The 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 were deprived an opportunity to receive the production license without an auction, and now must, upon completing exploration, bid for the production license at auction.

- The 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 a 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 15 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 a 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.
- A 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 November 10, 2009 obliges the GOU to ensure equal conditions

for receiving subsoil licenses for national and foreign investors.

Activity Licenses

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

A new law took effect on March 19, 2009 that 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 deposits of national significance.

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

- GOU Resolution No. 501 dated May 21, 2009 decreased the list of the documents the applicants need 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 does not possess Activity Licenses.

Negative trends include the GOU's intention¹ to strengthen the state's regulation of gas producers by introducing additional licensing for such activity as "sales of gas of own production" (in other words, a gas producing company in order to sell its own gas will need to obtain an Activity License). This measure, if adopted, will increase the State's influence on pricing for sales of produced gas. The respective bill was introduced by the GOU and is cur-

Government

rently pending at the Parliament.

Joint Activity Agreements (JAA) in 2009

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 percent 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 an 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 JAA party to the mineral resources extracted under this JAA, arguing that its right to dispose of the extracted hydrocarbons (gas) was restricted by the law.

In 2009, therefore, the risks involved in the exploration and production of natural resources under JAA have increased for private sector parties, while the confusing legal regime encourages state-owned

parties to default on their obligations under JAA. As was reported in the *Ekonomicheskaiia Gazeta* dated July 15, 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.

New CBM Law Adopted

In a positive and long-awaited development the Ukrainian Law "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 procedures for auctioning subsoil licenses for CBM extraction from coal deposits.

It appears that the CBM Law opens new exciting opportunities in subsoil use, primarily for those investors who

have relevant experience and implement modern technologies.

Production Sharing Regime

The production sharing agreement (PSA) regime has been paralyzed since the GOU challenged in 2008 the PSA it signed in 2007 (following the tender in 2006) with US-based Vanco International with regards to a large deep-water Prykerchenska block in the Black Sea. While this dispute is currently being considered by 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 1,000 square kilometers (while the current PSA Law does not limit the size of the blocks);
- Limiting Cost Recovery Production to 30 percent of the output (while the current PSA Law limits cost recovery production to 70 percent);
- 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 percent 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 bilingual 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 investor interest in the Black Sea and given 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.

1. NCRP Resolution No. 346 dated March 26, 2009.

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

RUSSIA TAX, LAW & BUSINESS BRIEFING

NEWLY UPDATED

Avoid financial and legal complications in your Russian business ventures with expert insight into the country's tax, labor, banking and business regulations. Written by an unparalleled network of reliable inside sources, regional journalists, and local editors, this one-of-a-kind resource brings you the information and analysis that will help you find success in the dynamic Russian markets.

Russia Tax, Law & Business Briefing brings you current analysis of Russia's overall economy. The expert insight inside the pages will help you . . .

- ◆ Learn how to weather a Russian audit and resolve tax disputes
- ◆ Find out if your organization is eligible for VAT savings based on new . . . and unpublicized . . . government practice
- ◆ Reduce the potential for labor disputes when you understand the country's new labor code
- ◆ Take advantage of cost savings resulting from Russia's most recent foreign economic regulation changes

For more information, including a table of contents and how to order . . . visit: www.wtexecutive.com